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Fiduciary Duties’ Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices

Heidi Mandanis Schooner*

The term “unsafe or unsound banking practices” serves as a statutory trigger for virtually every key administrative sanction available against bank directors. Congress has not defined either the term “unsafe or unsound banking practices” or its counterpart “safety and soundness,” leaving the federal banking agencies considerable discretion in the interpretation and application of the term. Given the potential breadth of the term, the banking agencies have the ability to seek administrative remedies in cases covering a broad range of director conduct. Thus, “unsafe or unsound banking practices” is a potent source of director liability.

Professor Schooner argues that “unsafe or unsound banking practices” and the common law fiduciary duty of care appear to share the same theoretical basis. Although both concepts are derived from negligence theory, Professor Schooner shows that they retain certain vital differences in application. In cases brought by the FDIC or the RTC as receivers for failed banks against bank directors for breach of the fiduciary duty of care, the business judgment rule requires courts to defer to directors’ business decisions. In reviewing administrative actions against bank directors for unsafe or unsound banking practices, however, courts must defer to the banking agencies’ determinations. Professor Schooner argues that, as a result of this difference in application, the principles of safety and soundness create a higher standard of care for bank directors than that imposed by the common law fiduciary duty of care. She suggests that this inconsistency proves most troublesome in the context of the agencies’ cease and desist power. She concludes that the banking agencies could remedy this inconsistency by adopting policies that implement any of several modest restraints on the potential breadth of the safety and soundness principle.

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What would be slight neglect in the care of a quantity of iron might be gross neglect in the care of a jewel. What would be slight neglect in the care exercised in the affairs of a turnpike corporation, or even of a manufacturing corporation, might be gross neglect in the care exercised in the management of a savings bank intrusted with the savings of a multitude of poor people, depending for its life upon credit and liable to be wrecked by the breath of suspicion.¹

Introduction

For most Americans today, the Federal Deposit Insurance Corporation ("FDIC") logo displayed on the teller window or automated teller machine

¹ Hun v. Cary, 82 N.Y. 65, 71 (1880).
offers assurance that their life's savings will not be lost because of the neglect of bank managers. As the bank failures of the 1980s demonstrated, FDIC insurance shifts the cost of bank failures from individual depositors to all taxpayers.

The existence of FDIC insurance, however, does not automatically place today's banks in the company of the turnpike or manufacturing corporation so vividly distinguished from the 19th-century savings bank by the New York Court of Appeals. Although individual depositors are largely sheltered from the direct effects of such failures, Congress's interest in preventing bank failures remains strong. Because the activities of bank directors are inevitably scrutinized when a bank fails, the debate continues over the standard of care owed by bank directors.

Recently, the controversy has centered on directors' liability for monetary damages in suits brought by the FDIC and the Resolution Trust Corporation ("RTC"), acting as receivers for failed institutions. In these receivership cases, the FDIC and the RTC have asserted that directors are personally liable for their negligent acts under state law. In response, directors have urged that Congress has prescribed gross negligence as the standard of care applicable to bank directors. In the context of receivership actions, however, this debate is not likely to continue for long with the same vigor. As the number of bank failures continues to decrease, we should witness a

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2 The FDIC insures deposits up to $100,000 in accordance with certain rules regarding aggregation of deposits and other limitations. 12 U.S.C. § 1821 (Supp. V 1993).

3 In this Article, the term "bank" refers to both commercial banks and savings institutions.


5 The FDIC was created in 1933. Banking Act of 1933, ch. 89, sec. 8, § 12A, 48 Stat. 162, 168-80 (1933).

6 See supra text accompanying note 1.

7 Congress's particular interest in bank failures is evidenced by the "special bank insolvency regime" described by Professor Swire in his comprehensive article on bank insolvency. See Peter P. Swire, Bank Insolvency Law Now that It Matters Again, 42 DUKE L.J. 469, 477-90 (1992).

8 See infra part I.

9 See infra part I.B.

10 The FDIC serves as receiver for failed commercial banks. The RTC serves as receiver for failed thrifts. The term "receiver" means "a receiver, liquidating agent, conservator, commissioner, person, or other agency charged by law with the duty of winding up the affairs of a bank or savings association or of a branch of a foreign bank." 12 U.S.C. § 1813(j) (Supp. V 1993). The FDIC is also the primary federal regulator for state-chartered, federally insured banks that are not members of the Federal Reserve System. 12 U.S.C. § 1813(q)(3) (Supp. V 1993). The RTC has no regulatory role.

11 See infra part I.B.

12 See infra part I.B.

13 In 1993, 42 commercial banks failed (compared to 1992, when 100 commercial banks failed). This is the lowest number of commercial bank failures since 1982. In 1993, eight savings institutions failed (compared to 1992, when 81 savings institutions failed). Bill to Ensure Fair Treatment of U.S. Banks Abroad Progresses in House, Fed. Banking L. Rep. (CCH) No. 1539, at 3 (Mar. 18, 1994) (temporary pamphlet). The total number of commercial banks and savings
corresponding drop in the number of actions brought against bank directors by the FDIC and RTC as receivers.  

Bank directors, however, cannot drop their guard. With the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), Congress directed the federal banking agencies to exercise their enforcement muscle long before an institution fails or faces imminent threat of failure. FDICIA, with its provisions for prompt corrective action, forces the regulators to assume a more formal and proactive role with regard to supervision of operating institutions. Under FDICIA, the source of liability for bank directors will likely shift from the receivership actions brought by the FDIC and RTC to the formal enforcement actions brought by all of the federal banking agencies.

Unsafe or unsound banking practices long have served as a trigger for director liability under every important formal enforcement provision in the federal banking laws. These provisions include cease and desist powers (which can include the recovery of monetary damages); removal from office; prohibition from participation in the banking industry; and civil money penalties of up to one million dollars per day. Principles of safety and soundness, therefore, are an important source of bank directors’ duties.

Institutions considered “problem” institutions also has declined dramatically from 1492 in December 1990 to 433 in June 1994. FDIC Q. BANKING PROFILE 17 (Second Quarter 1994).

In fact, the RTC will be dissolved no later than December 31, 1995, and the FDIC will take over its role as receiver for all failed depository institutions. 12 U.S.C. § 1441a(m)(1) (Supp. V 1993).


All of the formal enforcement powers, except the removal and prohibition provisions, also are applicable to bank officers, other professionals, and the bank itself. See infra note 170 (describing the “institution-affiliated party”).

Surprisingly, the duties created by principles of safety and soundness have never received the degree of attention showered on the standard of care applicable in receivership actions. See Cindy A. Schipani, Should Bank Directors Fear FIRREA: The FDIC’s Enforcement of the Financial Institutions Reform, Recovery and Enforcement Act, 17 J. CORP. L. 739 (1992); David B. Fischer, Comment, Bank Director Liability Under FIRREA: A New Defense for Directors and Officers of Insolvent Depository Institutions—or a Tighter Noose?, 39 UCLA L. REV.
Despite Congress's frequent reliance upon the phrases “unsafe or unsound” and “safety and soundness,” Congress never defined either phrase—leaving that task to the agencies. The regulators' authority to prescribe unsafe or unsound banking practices often serves as the statutory basis for specific regulation of bank operations. This Article, however, focuses on unsafe or unsound banking practices as a source of a general duty of care for bank directors. This Article concludes that unsafe or unsound banking practices should not be used to create a standard of care that is more onerous than the standard ordinarily applicable to bank directors' conduct. If Congress or the regulators wish to impose a higher standard of care on bank directors, this should be accomplished by law or regulation, not by formal enforcement actions based on unsafe or unsound banking practices.

Following this Introduction, Part I introduces bank directors' common law fiduciary duty of care, discusses federal statutory preemption of those duties, and highlights the effect of the business judgment rule on the discharge of those duties. Drawing on legislative history and court and banking agency interpretations, Part II attempts to identify a general definition for unsafe or unsound banking practices. This Part concludes that safety and soundness serves as an important gap-filler in the regulatory scheme and that the agencies, when considering safety and soundness as a basis of director liability, seem to view it as part of directors' fiduciary duties.

Part III addresses the agencies' application of unsafe or unsound banking practices as a basis for director liability. It analyzes the formal enforcement provisions that rely upon unsafe or unsound banking practices as a trigger for director liability and outlines the circumstances that typically give rise to a finding that a director has engaged in an unsafe or unsound banking practice. Next, Part IV compares the theoretical foundations of unsafe or unsound banking practices with those of fiduciary duty, concluding that both principles share negligence theory as a common underpinning.
Given their similarities, Part V attempts to reconcile bank directors' safety and soundness duty with their fiduciary duty. Part V begins by comparing the receivership cases brought against directors for breach of fiduciary duty with the formal enforcement actions brought against directors for unsafe or unsound banking practices. This Part observes that both types of cases rely upon negligence theory; yet, it notes that in receivership cases the courts defer to directors' judgments (through the operation of the business judgment rule or exculpatory state statutes), while in formal enforcement actions the courts defer to the agencies' judgments (through the operation of basic principles of administrative law). This Part explores the justification for treating bank directors' business judgments differently in these contexts and determines that although the inconsistency may be resolved in part through the operation of independent standards of culpability as required in most of the formal enforcement actions, some inconsistency remains. To resolve this inconsistency, Part V concludes that the federal banking agencies should adopt enforcement policies that require all formal enforcement actions brought against directors for unsafe or unsound banking practices to meet at least the standard of culpability required in receivership cases.

I. Bank Directors' Fiduciary Duty of Care

All corporate directors owe a fiduciary duty of care\(^\text{27}\) to their institutions.\(^\text{28}\) Courts, however, offer varied interpretations of this duty as applied to the conduct of bank directors. This Part provides an overview of bank directors' duty of care. It discusses the effect of federal preemption on the duty of care in the context of receivership actions brought by the FDIC and RTC as well as the business judgment rule's effect on the duty of care.

\(\text{27}\) The term "fiduciary" can cause confusion because of the term's use in the law of trusts. For this reason, the drafters of the \textit{Model Business Corporation Act} avoided the term "fiduciary" in establishing the general standard of care for all directors. See \textit{Model Business Corp. Act} § 8.30 cmt. 1 (1991); see also infra part I.A (discussing the duty of care).

\(\text{28}\) For a discussion of whether the duty of care is owed to third parties such as depositors, borrowers, or federal regulators, see Lawrence G. Baxter, \textit{Fiduciary Issues in Federal Banking Regulation}, 56 \textit{Law & Contemp. Probs.} 7 (1993).
A. Duty of Ordinary Care

Long before the banking crises of the 1930s and the 1980s, the Supreme Court articulated the duty of care for bank directors. In 1891, the Supreme Court held in *Briggs v. Spaulding*\(^ {29} \) that "directors must exercise ordinary care and prudence in the administration of the affairs of a bank."\(^ {30} \) This flexible standard, derived from tort law, "depends upon the subject to which it is to be applied, and each case has to be determined in view of all the circumstances."\(^ {31} \) Since *Briggs*, many courts have applied this duty of ordinary care in evaluating the conduct of bank directors.\(^ {32} \)

Most courts and commentators accept *Briggs* as the source of bank directors' duty of care\(^ {33} \) but have interpreted that duty inconsistently. Although the Supreme Court in *Briggs* sets forth a standard of ordinary care, there is language in the case that suggests that the Court applied a standard of gross negligence.\(^ {34} \) Even so, some courts, relying on *Briggs* and other older decisions, have applied a standard of care to bank directors that is more demanding than the standard applied to other corporate directors.\(^ {35} \)

\(^{29}\) 141 U.S. 132 (1891). The receiver of the First National Bank of Buffalo brought this action against the former directors of the bank for their failure to manage properly the bank's affairs. *See id.* at 134-40.

\(^{30}\) *Id.* at 165. The Court found that the duty of ordinary care includes something more than officiating as figure-heads. [Directors] are entitled under the law to commit the banking business, as defined, to their duly-authorized officers, but this does not absolve them from the duty of reasonable supervision, nor ought they to be permitted to be shielded from liability because of want of knowledge of wrong-doing, if that ignorance is the result of gross inattention . . . .

*Id.* at 165-66 (emphasis added).

\(^{31}\) *Id.* at 147. This duty of care is consistent with the duty of care set forth in the *Model Business Corporation Act*, which provides that a director must act "with the care an ordinarily prudent person in a like position would exercise under similar circumstances." *Model Business Corp. Act § 8.30(a)(2) (1991).*


\(^{34}\) *See supra* note 30 (quoting Court language that imposes director liability for "gross inattention"); *see also* McMurray, Note, *supra* note 27, at 622 n.109 (citing *Briggs* as holding directors to a gross negligence standard).

Application of the higher standard\textsuperscript{36} stems perhaps from the recognition that conduct that amounts to ordinary care in the affairs of some businesses may not amount to ordinary care in the affairs of a bank.\textsuperscript{37} The desire to protect depositors from the loss of their life savings undoubtedly influenced this rationale's formulation, which predates the creation of the federal deposit insurance program.\textsuperscript{38} Nevertheless, even with FDIC insurance coverage, some recent decisions have held bank directors to a higher degree of care than that owed by other corporate directors.\textsuperscript{39}

\textbf{B. Statutory Preemption in Receivership Cases}

Directors' common law duty of care becomes a central issue when a bank becomes insolvent. When a bank fails, the FDIC and the RTC have the power as receivers to step into the shoes of the failed bank. To recoup losses incurred by the bank, the FDIC and the RTC may sue former directors for breach of the fiduciary duties owed to their institutions.\textsuperscript{40} Because Congress has spoken on this subject, the issue becomes whether, in actions brought by the FDIC or RTC as receivers, the traditional common law duties owed by directors have been preempted by federal statute.

\textsuperscript{36} Of course, courts that purport to apply a higher standard of care to a bank director's conduct are simply recognizing that the circumstances surrounding the affairs of a bank, i.e., the safekeeping of customers' deposits, may require a different type of conduct in discharging the duty of ordinary care. Such circumstances do not raise the standard of care above ordinary care but affect the manner in which the duty of ordinary care is met.

\textsuperscript{37} See supra note 1 and accompanying text. Conversely, one district court noted the danger in this type of reasoning:

\textit{I}f, as here, we are considering bank directors, the ordinary bank director, that is, the person who ordinarily acts as such a director, is the standard of comparison to be used as the criterion by which the requisite care must be measured and determined, and, unless the court keeps that in mind . . . there is danger that the court may impose upon the defendants a greater duty than is required by the applicable rule of law. The natural impulse of the judge trying such a case is to expect and demand a high degree of care on the part of such a bank director and to believe that the ordinary bank director is, as the judge is likely to conceive that he himself would be (and perhaps in fact would be), a very careful, conservative, prudent director. It is only natural for a judge to think of himself as a bank director of this ultraconservative type, rather than as a director of the average, ordinary type.


\textsuperscript{38} Schipani, supra note 22, at 742.

\textsuperscript{39} \textit{Id.} at 750-51 (discussing the decision in \textit{Biliman v. State of Maryland Deposit Insurance Fund Corp.} as an example of a recent decision holding bank directors to a higher degree of care).

Moreover, the existence of FDIC insurance may serve as a basis for expanding, rather than contracting, the duties of bank directors because federal regulators have argued that federally insured banks and their officers and directors owe a fiduciary duty to the regulators themselves. \textit{See} Baxter, supra note 28, at 15-31 (arguing against the application of a fiduciary duty in favor of the federal regulators).

\textsuperscript{40} Because the receiver steps into the shoes of the bank itself, it may bring any actions that would have been available to the failed bank. \textit{See} O'Melveny \& Myers v. FDIC, 114 S. Ct. 2048, 2054 (1994). It is not unusual for the FDIC or RTC, as receivers, or any of the banking regulators, to rely on a fiduciary duty owed to a third party as a basis for a receivership action or a formal enforcement proceeding. \textit{See} Baxter, supra note 28, at 14.
The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") amended section 1821(k) of the Federal Deposit Insurance Act ("FDIA"). The FDIA allows the FDIC and the RTC, acting as receivers, to bring actions against bank directors for monetary damages. Section 1821(k) imposes liability on directors for gross negligence as defined by applicable state law but contains a savings clause that provides that "[n]othing in this paragraph shall impair or affect any right of the [FDIC or RTC] under other applicable law." Because some state laws and arguably federal common law hold bank directors to a standard of ordinary care—a higher degree of care than gross negligence—FIRREA has required courts to address the issue of whether section 1821(k) preempts state law, federal common law, or both.

The Ninth and Tenth Circuits have held that section 1821(k) does not preempt a state cause of action for simple negligence. The majority of district courts concur. The Seventh Circuit, however, has relied on choice of law principles to find that a state law cause of action is not available to the

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42 Federal Deposit Insurance Act, ch. 967, 64 Stat. 873 (1950).
43 Section 1821(k) provides that a bank director or officer "may be held personally liable for monetary damages in any civil action by [the FDIC or RTC] . . . for gross negligence . . . as such terms are defined and determined under applicable State law." 12 U.S.C. § 1821(k) (Supp. V 1993).
45 The language of the Briggs decision could be used to support either a simple negligence standard or a gross negligence standard. See supra note 34 and accompanying text. But see Ronald W. Stevens & Bruce H. Nelson, The Standard of Care for Directors and Officers of Federally Chartered Depository Institutions: It's Gross Negligence Regardless of Whether Section 1821(k) Preempts Federal Common Law, 13 ANN. REV. BANKING L. 169, 193 (1994) (arguing that the federal common law standard should be gross negligence).
46 See supra part I.A. The fiduciary duty of ordinary care can be described as a simple negligence standard. Although breach of fiduciary duty and negligence are typically pled as separate causes of action (and different statutes of limitations may apply), they theoretically involve the same level of care because the concept of "ordinary care" is equivalent to the "reasonable person" standard of care in negligence theory. See infra note 228 (discussing the Restatement (Second) of Torts). Consequently, some district courts have treated claims of breach of fiduciary duty as analytically equivalent to claims of negligence. See RTC v. Vanderweele, 833 F. Supp. 1383, 1386-87 (N.D. Ind. 1993) (mem.); Washington Bancorporation v. Said, 812 F. Supp. 1256, 1271 (D.D.C. 1993) (mem.).
47 See Schipani, supra note 22; Fischer, Comment, supra note 22; Price, Note, supra note 22.
48 See FDIC v. McSweeney, 976 F.2d 532, 539 (9th Cir. 1992), cert. denied, 113 S. Ct. 2440 (1992); FDIC v. Canfield, 967 F.2d 443, 448 (10th Cir.) (en banc), cert. dismissed, 113 S. Ct. 516 (1992). Both courts found that the language of § 1821(k) preserves a state cause of action for simple negligence. See McSweeney, 976 F.2d at 538; Canfield, 967 F.2d at 446.
RTC in a suit against directors of a federally chartered financial institution conducting business in more than one state. With respect to federal common law governing officer and director liability, the Fifth and Seventh Circuits have held that section 1821(k) preempts any federal common law in suits brought by the FDIC or RTC as receivers. Several district courts have reached the same conclusion.

C. Effect of the Business Judgment Rule on Common Law Duties

Cases alleging a breach of the fiduciary duty of care involve often a review of directors' business judgments. Inherently, business judgments involve risk-taking, and risk-taking sometimes leads to losses. In reviewing these judgments, however, courts have expressed the need to refrain from second-guessing directors' business decisions. This judicial deference provides the foundation for the business judgment rule.

The business judgment rule manifests itself in several different forms. Under the recently adopted American Law Institute ("ALI") version of the business judgment rule, directors fulfill their duty of care if they (1) make disinterested business judgments on an informed basis, to the extent they reasonably believe is appropriate under the circumstances, and (2) rationally believe that the business judgment made is in the best interest of the

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50 RTC v. Chapman, 29 F.3d 1120, 1122-24 (7th Cir. 1994). The Seventh Circuit applied the internal affairs doctrine, which "recognizes the benefits of using one rule of law to determine the duties and liability of directors and officers whose firm may do business in many states." Id. at 1122. Because the case was against the former officers and directors of the Security Savings and Loan Association—a federally chartered financial institution doing business in more than one state—the Seventh Circuit held that federal, not state, law applied. Id. at 1124. But see RTC v. Everhart, 37 F.3d 151, 153-54 (4th Cir. 1994) (rejecting Chapman’s application of the internal affairs doctrine and holding that a state statute of limitations is available to the RTC in a suit against directors of a federally chartered financial institution).

51 See RTC v. Miramon, 22 F.3d 1357, 1360 (5th Cir. 1994); RTC v. Gallagher, 10 F.3d 416, 420 (7th Cir. 1993). Because of a recent Supreme Court decision, it is questionable whether there is a federal common law governing the duty of care of bank directors. See O’Melveny & Myers v. FDIC, 114 S. Ct. 2048, 2052-54 (1994) (finding no federal common law governing the tort liability of attorneys providing services for banks in receivership).


54 For a discussion of the origins of the business judgment rule, see Arsh, supra note 27, at 97-100.

corporation. The effect of the ALI business judgment rule is to apply (1) a standard of ordinary care to directors’ decisionmaking process and (2) a lesser standard (gross negligence, perhaps) to the substance of the decision.

Delaware’s business judgment rule is expressed as a presumption that directors have “acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” The application of the Delaware rule, in effect, turns the directors’ fiduciary duty of care into a gross negligence standard of care. Commentators have concluded that the Delaware rule “means that greater deference will be given to any evidence presented by the defendant-directors and, thus, more evidence will be required of the plaintiff.” Others interpret the Delaware rule as a substantive legal rule that, like the ALI rule, “limits the duty of care solely to

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56 The ALI provision provides as follows:
A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer:
(1) is not interested . . . in the subject of the business judgment;
(2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
(3) rationally believes that the business judgment is in the best interests of the corporation.

57 Professor Gevurtz explains:
Essentially, the ALI proposes to focus the protective thrust of the business judgment rule on limiting judicial scrutiny of the substance of the directors’ decision. The ALI formulates a standard of reasonable belief regarding the process the directors use to reach their decision, or, more specifically, whether directors gathered adequate information before acting. This would appear consistent with the norm of ordinary negligence. When it comes to the substance of the directors’ decision, however, the ALI’s proposed version of the business judgment rule lowers the standard of care to a rational belief. The ALI’s comments suggest this rational belief standard may be similar to an absence of gross negligence.

Gevurtz, supra note 55, at 301 (footnote omitted).


59 The court in Aronson explained that “[w]hile the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.” Id. at 812; see also Stevens & Nielson, supra note 45, at 191 (“Like Delaware, many states have adopted and applied the business judgment rule so as to create a gross negligence standard of care for directors and officers.”). But see RTC v. Heiserman, 839 F. Supp. 1457, 1463 (D. Colo. 1993) (mem.) (“[T]he business judgment rule does not convert ordinary negligence to gross, willful or wanton negligence, but rather, it is an affirmative defense to an ordinary negligence claim.”).

60 Balotti & Hanks, supra note 55, at 1348.
the process by which the decision is reached and prevents liability if the decision was made with the requisite good faith."\textsuperscript{61}

Bearing in mind the different forms of the business judgment rule,\textsuperscript{62} the rule generally defers to directors' decisions and focuses a court's review of those decisions on the decisionmaking process rather than on the decisions' content or results; the inquiry centers on whether the directors were informed and whether they acted in good faith and without conflicts of interest.\textsuperscript{63}

Significant authority supports the proposition that the business judgment rule applies to the conduct of bank directors.\textsuperscript{64} In addition, the banking agencies' enforcement guidelines support the application of the business judgment rule.\textsuperscript{65} This agency support, however, seems incongruous when juxtaposed with the FDIC and RTC positions in recent receivership cases arguing in favor of applying a simple negligence standard.\textsuperscript{66} Nevertheless, in the final analysis, most states, through the operation of the business judgment

\textsuperscript{61} Hansen, supra note 55, at 1361.

\textsuperscript{62} See supra notes 55-61 and accompanying text.

\textsuperscript{63} For an in-depth discussion of all of the elements comprising the business judgment rule, see Hansen, supra note 55, at 1363-69.


Some authority, however, supports the proposition that the judicial deference afforded to directors by the business judgment rule should not apply to bank directors. See Holland v. American Founders Life Ins. Co., 376 P.2d 162, 166 (Colo. 1962); Allied Freightways, Inc. v. Cholfin, 91 N.E.2d 765, 768 (Mass. 1950); Cosmopolitan Trust Co. v. Mitchell, 136 N.E. 403, 408 (Mass. 1922). Moreover, the authority supporting the application of a higher standard of care for bank directors (i.e., a higher standard than applied to other corporate directors) could be used to argue that the business judgment rule should not apply to bank directors. See supra notes 35-39 and accompanying text (discussing the authority imposing a higher standard of care on bank directors).

\textsuperscript{65} For example, the OTS issued a statement in 1992 regarding the duties of bank directors that provides: "The OTS will not bring civil claims against directors and officers who fulfill their responsibilities, including the duties of loyalty and care, and who make business judgments on a fully informed basis and after proper deliberation." Statement Concerning the Responsibilities of Directors and Officers of Insured Depository Institutions, OTS 92-163 (Nov. 16, 1992) (emphasis added).

Similarly, in a cover letter to the FDIC's guidelines on director liability, FDIC General Counsel Alfred J.T. Byrne wrote: "The FDIC wants to make clear that it will not bring civil suits against those who fulfill their responsibilities and who make reasonable business judgments on a fully informed basis and after proper deliberation." New FDIC Guidelines Issued to Clarify the Responsibilities of Directors and Officers, FDIC FIL-87-92 (Dec. 17, 1992) (quotation omitted) (emphasis added). The Federal Home Loan Bank Board ("FHLBB") (the former regulator of thrifts) issued a policy statement in 1987 strongly supporting the business judgment rule. Accountability of Directors and Officers; Policy Statement, 52 Fed. Reg. 22,682, 22,683 (1987) ("[T]he FHLBB's intent is not to second-guess directors and officers who have exercised business judgment after due diligence and reasonable care in the performance of their duties.").

\textsuperscript{66} See supra part I.B.
rule or other exculpatory statutes, would give deference to the decisions of bank directors, holding them effectively to a gross negligence standard, rather than a more onerous standard like simple negligence.

II. Directors' Safety and Soundness Duty: Defining Unsafe or Unsound Banking Practices

Setting aside for the moment bank directors' fiduciary duty of care, bank directors have duties that arise from regulatory principles of safety and soundness. This Part seeks to identify a general definition for unsafe or unsound banking practices, considering congressional intent and both court and agency interpretations.

A. Introduction: The Regulatory Gap-Filler

Safety and soundness, an "amorphous concept," is an essential principle in the regulation of the banking industry. Congress intended "unsafe or unsound banking practices" to be a broad, generic term, without strict definition. Because Congress left it to the agencies to decide what practices are unsafe or unsound, principles of safety and soundness act to close the gaps in the regulatory framework.

This gap-filler is necessary given the complexities of the banking industry. Despite the fact that the banking industry is one of the most highly regulated industries in this country, neither Congress nor the federal banking agencies could (or should) attempt to regulate specifically each and every bank activity. Any such attempt would prove prohibitively costly and would

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67 For a survey of these state laws, see Schipani, supra note 22, at 751-56; Stevens & Nelson, supra note 45, at 193-231. Note, however, that statutes exculpating acts of gross negligence would be preempted by § 1821(k)'s gross negligence standard in receivership actions by the FDIC and RTC. See FDIC v. Canfield, 967 F.2d 443, 446 (10th Cir.) (en banc), cert. dismissed, 113 S. Ct. 516 (1992); FDIC v. Swager, 773 F. Supp. 1244, 1246 (D. Minn. 1991) (mem).

68 See, e.g., RTC v. Miramon, 22 F.3d 1357, 1365 n.13 (5th Cir. 1994) (declining consideration of whether § 1821(k) preempts a more onerous state standard because Louisiana's standard of care is gross negligence).

69 Franklin Sav. Ass'n v. Director, OTS, 934 F.2d 1127, 1145 (10th Cir. 1991), cert. denied, 112 S. Ct. 1475 (1992).

70 See infra part II.B.


72 The regulatory burden on banks draws constant criticism from bankers. See Shannon Henry, IBAA's Casey Leads Charge Against Red Tape, Am. Banker, Mar. 17, 1994, at 8 (noting that bank regulation has quintupled since 1985). The regulators themselves share these concerns. See Claudia Cummins, Fed's LaWare Sees Red Tape Struggle Growing for Banks, Am. Banker, June 14, 1994, at 1 (noting that a Federal Reserve Governor predicted even greater regulatory burdens on banks in the future); Shannon Henry, OCC Official Rewrites the Rules to Smooth the Regulatory Process, Am. Banker, May 12, 1994, at 8 (discussing an OCC goal to comprehensively review national bank regulation). One of the primary justifications for the heavy regulatory burden on banks is the moral hazard inherent in our banking system: because bank managers know that failed-bank losses will be borne principally by the FDIC, they are arguably encouraged to take excessive risks. See Geoffrey P. Miller, The Future of the Dual Banking System, 53 Brook. L. Rev. 1, 18-19 (1987).
likely fail. Moreover, neither Congress nor the regulators are likely to possess the prescience to enact laws and regulations that would address rapid changes in the banking industry.

When Congress or the regulators determine to prescribe an aspect of banks' operations, directors must ensure banks' compliance. But even in those instances where Congress or the regulators have not addressed an area of bank operations, directors must act in accordance with the gap-filling principles of safety and soundness.

Principles of safety and soundness have been a source of directors' duties since as early as 1933 when Congress authorized removal proceedings against national bank directors for unsafe or unsound banking practices. Today, unsafe or unsound banking practices serve as a statutory trigger for every important formal enforcement proceeding available against bank directors. Although a violation of law or regulation often constitutes an unsafe or unsound banking practice, the difficulty lies in identifying those unsafe or unsound banking practices that do not also violate a law or regulation. The remainder of Part II addresses this difficulty.

B. Congress's Definition of Unsafe or Unsound Banking Practices

Although Congress has never defined unsafe or unsound banking practices, it has described certain discrete practices as unsafe or unsound.

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73 Commenting on the dangers of a specific definition for safety and soundness, one Administrative Law Judge stated that the formulation of such a definition would probably operate to exclude those practices not set out in the definition, even though they might be highly injurious to an institution under a given set of facts or circumstances or a scheme developed by unscrupulous operators to avoid the reach of the law.


76 For a discussion of these formal enforcement proceedings, and the liability that can result from such proceedings, see infra part III.A.

77 See, e.g., First Nat'l Bank of Eden v. Department of the Treasury, 568 F.2d 610, 611 n.1 (8th Cir. 1978) (per curiam) (noting that an unsafe or unsound practice included a failure to maintain adequate credit information on certain bank investments in violation of 12 C.F.R. § 1.8); Richard M. Roberson, FDIC-92-122e, 1994 FDIC Enf. Dec. LEXIS 47, at *41 (Feb. 22, 1994) (stating that a violation of state lending limit statutes constituted an unsafe or unsound banking practice).

78 For example, the Director of the OTS may treat the failure of any savings association to
addition Congress, in 1991, required each federal banking agency to adopt regulations prescribing standards for safety and soundness in three areas: (1) operations and management, (2) asset quality, earnings, and stock valuation, and (3) employee compensation. 79

Apart from these piecemeal statutory indications of what Congress means by unsafe or unsound banking practices, the only evidence of congressional intent comes from legislative history. Relevant legislative history includes the hearings concerning the Financial Institutions Supervisory Act of 1966 ("FISA"). 80 FISA gave the agencies, inter alia, the power to issue cease and desist orders in certain circumstances. 81 Under FISA, one of the bases for the use of such power was the finding of unsafe or unsound banking practices. 82

During the debates on FISA, several members of Congress expressed concern over the vagueness of the term unsafe or unsound banking practices. 83 In response, John Horne, then-Chairman of the Federal Home Loan Bank Board, wrote a memorandum that explained:

Like many other generic terms widely used in the law, such as "fraud," "negligence," "probable cause," or "good faith," the term "unsafe or unsound practices" has a central meaning which can and must be applied to constantly changing factual circumstances. Generally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds. 84

This memorandum has been cited as the "authoritative definition of an unsafe or unsound [banking] practice." 85

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81 See infra notes 171-173 and accompanying text (discussing the agencies' cease and desist power).
83 See 112 CONG. REC. 24,984 (1966) (statement of Rep. Patman) (noting that other members of Congress had been concerned about the exact meaning of unsafe or unsound banking practices); id. at 25,008 (statement of Rep. Holifield) (expressing concern that no clear definition of unsafe or unsound banking practices existed).
The only other significant legislative history, also from the 1966 FISA hearings, suggests that violations of safety and soundness must involve a risk to the federal bank insurance fund. Representative Wright Patman, then-Chairman of the House Committee on Banking and Currency, explained the breadth of the delegation of cease and desist and removal powers to the agencies: “[T]he cease-and-desist powers and management removal powers are aimed specifically at actions impairing the safety or soundness of our insured financial institutions. These new flexible tools relate strictly to the insurance risk and to assure the public of sound banking facilities.” This language suggests that Congress has viewed safety and soundness-based regulation as a guard against the threat of bank insolvency.

C. Courts’ Definition of Unsafe or Unsound Banking Practices

Because the vast majority of formal enforcement actions against banks and their officers and directors are settled by consent, the courts have had few opportunities to consider the meaning of unsafe or unsound banking practices. When confronted with the issue, courts have deferred to the agencies’ interpretation of the statutory language.

In seeking a general definition for unsafe or unsound banking practices, the courts have relied on either Chairman Horne’s definition or one almost identical to it. The courts in the latter group follow the Eighth Circuit in defining unsafe or unsound banking practices as “conduct deemed contrary

88 See also Baxter, supra note 28, at 27 (arguing, inter alia, that the statutory structure of the formal enforcement provisions “strongly suggests that Congress has always assumed that the safety/soundness principle took care of actions carrying risks of insolvency”).
90 To the extent that courts acknowledge varying degrees of deference, the deference afforded the federal banking agencies with regard to the interpretation of unsafe or unsound practices is “particularly deferential.” Franklin Sav. Ass'n v. Director, OTS, 934 F.2d 1127, 1145-46 (10th Cir. 1991), cert. denied, 112 S. Ct. 1475 (1992); see also First Nat'l Bank of Lamarque v. Smith, 610 F.2d 1258, 1264 (5th Cir. 1980) (“The Comptroller has wide discretion in the field of national banking . . .”); Heimann, 613 F.2d at 1168-69 (“[T]he Comptroller's discretionary authority to define and eliminate 'unsafe and unsound' conduct is to be liberally construed.”). See generally Lawrence G. Baxter, The Rule of Too Much Law? The New Safety/Soundness Rulemaking Responsibilities of the Federal Banking Agencies, 47 CONSUMER FIN. L.Q. REP. 210, 211-12 (1993) (stating that “banking agencies have been accorded a broad latitude to implement their safety/soundness regulatory powers”).
91 See, e.g., In re Seidman, 37 F.3d 911, 926-27 (3d Cir. 1994); Simpson v. OTS, 29 F.3d 1418, 1425 (9th Cir. 1994); MCorp, 900 F.2d at 863.
to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder." 91 Two differences between the Eighth Circuit's definition and Chairman Horne's definition are apparent. First, the Eighth Circuit's definition refers to "accepted standards of banking operations"92 and Chairman Horne's definition refers to "accepted standards of prudent operation." 93 Second, the Eighth Circuit's definition targets a loss to "a banking institution or shareholder"94 and Chairman Horne's definition targets a loss to "an institution, its shareholders, or the agencies administering the insurance funds."95 The courts provide no indication that they deem these differences significant.96

The Tenth Circuit has indicated that a finding of unsafe or unsound banking practices is a "predictive judgment (i.e., what may happen if this

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91 The Eighth Circuit attributes the wording of this definition to the Comptroller of the Currency. First Nat'l Bank of Eden v. Department of the Treasury, 568 F.2d 610, 611 n.2 (8th Cir. 1978) (per curiam). The following decisions rely on the definition provided in Eden: Seidman, 37 F.3d at 927, Northwest National Bank, Fayetteville, Arkansas v. United States, 917 F.2d 1111, 1115 (8th Cir. 1990), First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674, 685 (5th Cir. 1983), and Smith, 610 F.2d at 1265.

In a later Eighth Circuit decision, however, the court defined unsafe or unsound banking practices as "an abnormal risk of loss or harm contrary to prudent banking practices." Van Dyke v. Board of Governors of the Fed. Reserve Sys., 876 F.2d 1377, 1380 (8th Cir. 1989) (emphasis added). This definition seems to combine Chairman Horne's language and the language attributed by the Eighth Circuit to the Comptroller.

92 See supra text accompanying note 91 (emphasis added).

93 See supra text accompanying note 84 (emphasis added).

94 See supra text accompanying note 91.

95 See supra text accompanying note 84.

96 In a recent decision, the Third Circuit quoted both definitions without discussion of the significant differences between the two. See In re Seidman, 37 F.3d 911, 926-27 (3d Cir. 1994). The first distinction, i.e., banking operations versus prudent operations, is a theoretical one that may have little practical effect. Arguably, the Eighth Circuit's definition is less favorable to the agencies because "accepted standards of banking operations" suggest the need to establish the violation of some objective standard. "[S]tandards of prudent operation," on the other hand, perhaps would allow for a more subjective determination by the agencies. The second distinction has greater potential significance. Chairman Horne's definition proscribes conduct that might result in a loss to the bank, its shareholders, or the FDIC as insurer (i.e., the agency administering the insurance funds). See supra text accompanying notes 84, 91. The Eighth Circuit definition does not include a reference to potential losses to the FDIC. This variation is potentially significant because proscribing conduct that might result in an abnormal risk or loss to the FDIC as insurer is not necessarily the same as prohibiting conduct that might result in an abnormal risk or loss to the institution or its shareholders. For example, engaging in a risky business transaction with potential for great financial returns may not constitute an abnormal risk or loss to the bank or its shareholders who ultimately seek to maximize profits. On the other hand, the same activity may be viewed as an abnormal risk or loss to the FDIC, which has interests in avoiding the bank's insolvency and not in maximizing profits. Although the courts addressing the definition of unsafe or unsound banking practices have not focused their analysis on the risk to the FDIC as insurer, some courts have indicated that a finding of unsafe or unsound banking practices must involve a risk to the bank's financial integrity. See infra notes 102-117 (discussing the Fifth Circuit's Gulf Federal decision and its progeny). The courts' analyses in these decisions, however, do not appear to be based on the differences between the Chairman Horne definition and the Eighth Circuit definition.
The principle of safety and soundness is "progressive"—its application depends upon the circumstances of the particular case. What may be an acceptable practice for one bank may be unsafe or unsound for another.

Although the courts have concluded that Congress never intended to define unsafe or unsound, choosing instead to leave the implementation of the phrase to the agencies, the courts have not blindly adopted the agencies' interpretation of the term. The first judicial recognition of a limitation on the breadth of safety and soundness was in *Gulf Federal Savings and Loan Ass'n v. Federal Home Loan Bank Board*, in which the Fifth Circuit limited

97 Franklin Sav. Ass'n v. Director, OTS, 934 F.2d 1127, 1146 (10th Cir. 1991), cert. denied, 112 S. Ct. 1475 (1992). The Tenth Circuit's characterization of safety and soundness determinations as "predictive judgments" is supported by the language of both Chairman Horne's and the Eighth Circuit's definitions. Chairman Horne's definition provides that unsafe or unsound banking practices involve conduct, "the possible consequences of which, if continued, would be abnormal risk or loss." See supra text accompanying note 84 (emphasis added). The Eighth Circuit's definition discusses conduct that "might result in abnormal risk or loss." See supra text accompanying note 91 (emphasis added).

98 See Groos Nat'l Bank v. Comptroller of the Currency, 573 F.2d 889, 897 (5th Cir. 1978) (rejecting an argument that unsafe or unsound lacks definite meaning by stating that one purpose of the banking acts "is clearly to commit the progressive definition . . . of such practices to the expertise of the appropriate regulatory agencies").

99 See *Franklin Sav.*, 934 F.2d at 1145 ("What constitutes an unsafe and unsound condition is somewhat of an amorphous concept, as it varies depending on the circumstances involved.").


The use of the phrase "unsafe or unsound practices" in the federal banking laws has been compared to the use of the language "unfair methods of competition" and "unfair or deceptive acts or practices" in the Federal Trade Commission Act. See Independent Bankers Ass'n of Am. v. Heimann, 613 F.2d 1164, 1169 (D.C. Cir. 1979), cert. denied, 449 U.S. 823 (1980); *** Bank *** Bank, FDIC-85-215e, 1986 FDIC Enf. Dec. LEXIS 10, at *55 n.16 (July 17, 1986). In each instance, Congress intentionally avoided precise language to allow "the meaning and application [to be] arrived at by the gradual process of inclusion and exclusion." *Id.* at *55 n.16.

102 651 F.2d 259 (5th Cir. July 1981), cert. denied, 458 U.S. 1121 (1982). It is important to note that the decision in *Gulf Federal* was rendered prior to the Supreme Court's decision in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), which mandates judicial deference to agencies on matters of statutory interpretation in cases involving ambiguous statutory language. *Id.* at 843-44. In *Gulf Federal*, the Fifth Circuit refused to defer to the agency's interpretation of the relevant statute's unsafe or unsound language. *See* 651 F.2d at 263.

After *Chevron*, the Fifth Circuit had occasion to consider again the interpretation of unsafe or unsound banking practices in *MCorp*. In *MCorp*, a bank holding company challenged the Fed's authority to require the holding company to serve as a "source of strength" to its bank subsidiaries by making its assets available to subsidiary banks that were suffering capital deficiencies. 900 F.2d at 853, 857. Despite the Fifth Circuit's willingness to grant the Fed deference, as *Chevron* requires, the court rejected the Fed's argument that its authority to order a holding company to cease and desist from unsafe or unsound banking practices gave it authority to issue the source-of-strength regulation. *Id.* at 862-63. The *MCorp* decision was affirmed in part and reversed in part, on other grounds, by the Supreme Court. *Board of Governors of the Fed. Reserve Sys. v. MCorp Fin., Inc.*, 502 U.S. 32 (1991).
the interpretation of unsafe or unsound banking practices to matters relating to the financial integrity of the financial institution.\textsuperscript{103}

Gulf Federal had maintained a policy of calculating interest on loans based on a 360-day year.\textsuperscript{104} Gulf Federal’s board decided to change its policy and use instead a 365-day year. Accordingly, it amended all of its loan documentation.\textsuperscript{105} Although the board decided later to return to a 360-day year, the bank never amended the loan documentation to reflect that change.\textsuperscript{106} As a result, Gulf Federal charged its customers on the basis of a 360-day year despite the fact that their contracts provided for a 365-day year.\textsuperscript{107}

The Federal Home Loan Bank Board\textsuperscript{108} ("Bank Board") found this practice unsafe or unsound and issued a cease and desist order.\textsuperscript{109} On appeal, the Fifth Circuit reversed the Bank Board’s decision, concluding that Gulf Federal’s use of inconsistent contract terms had only a remote relationship to Gulf Federal’s financial integrity.\textsuperscript{110} The Fifth Circuit found the principle of unsafe or unsound banking practices limited to “practices with a reasonably direct effect on [a financial institution’s] financial soundness.”\textsuperscript{111}

Respondents in formal enforcement actions often cite Gulf Federal as support for requiring the federal banking agencies to show that the conduct in question has a reasonably direct effect on an association’s financial soundness.\textsuperscript{112} Such a limitation, however, particularly when asserted in the context of an agency exercising its cease and desist power, proves an ineffective shield against liability for two reasons. First, although Gulf Federal has been cited favorably by the Ninth\textsuperscript{113} and Third\textsuperscript{114} Circuits, a number of administrative decisions reflect a refusal to apply the Gulf Federal limitation.\textsuperscript{115} Second,

\textsuperscript{103} See Gulf Fed., 651 F.2d at 267.
\textsuperscript{104} The court explained that the 360-day calculation is more favorable to the lender because “the interest rate is computed as though there were 360 days in the year but is charged to borrowers for 365 days.” Id. at 261.
\textsuperscript{105} Id.
\textsuperscript{106} Id.
\textsuperscript{107} Id. at 261-62.
\textsuperscript{108} In 1989, FIRREA replaced the Federal Home Loan Bank Board with the OTS as the federal regulator of savings institutions. 12 U.S.C. § 1463 (Supp. V 1993).
\textsuperscript{109} Gulf Fed., 651 F.2d at 262.
\textsuperscript{110} See id. at 264. The total amount that the customers were overcharged was approximately $80,000, compared to Gulf Federal’s assets of approximately $75 million. Id. at 264 n.4.
\textsuperscript{111} See id. at 264.
\textsuperscript{112} See infra note 115.
\textsuperscript{113} See Hoffman v. FDIC, 912 F.2d 1172, 1174 (9th Cir. 1990).
\textsuperscript{114} See In re Seidman, 37 F.3d 911, 927 (3d Cir. 1994).
\textsuperscript{115} The OTS rejected the inclusion of the Gulf Federal limitation in its definition of safety and soundness in the context of a cease and desist order, noting that “[a] requirement of such a showing is fundamentally inconsistent with the purpose of a cease and desist order, which is to try to stop harm to an institution before it occurs.” Neil M. Bush, No. ERC-90-30, 1991 OTS LEXIS 94, at *35 n.16 (Apr. 18, 1991) (Decision and Order). See infra notes 206-209 and accompanying text for further discussion on Bush. Similarly, the Administrative Law Judge in an OCC action rejected the application of Gulf Federal. *** *** Nat’l Bank of *** ***, OCC AA-EC-85-43; AA-EC-85-44 (consolidated) (date missing); cf. Fisher, supra note 86, at 66 (describing an unreported Fed removal order that asserted that safety and soundness “address[ ] the nature, rather than the degree, of the departure from ordinary standards of prudent banking”).
because safety and soundness involves a largely "predictive judgment," the Gulf Federal limitation may be confined to a requirement that a finding of unsafe or unsound banking practices must include a finding that the practices, if they continue, might threaten the financial integrity of the financial institution. Such a requirement is less demanding than requiring a finding that the practices actually threaten the financial integrity of the financial institution. In another case limiting the scope of unsafe or unsound banking practices, Otero Savings & Loan Ass'n v. Federal Home Loan Bank Board, the Tenth Circuit held that the Bank Board’s authority to ensure that financial institutions conduct their affairs in a safe and sound manner did not give it the authority to “use whatever means seem desirable to maintain the competitive balance among financial institutions.” Otero Savings and Loan (“Otero”) began to offer its customers interest-bearing checking accounts over eight months before such accounts became legal under the Depository Institutions Deregulation Act of 1980. The Bank Board ordered Otero, inter alia, to cease opening any new interest-bearing checking accounts for 268 days. By the time the Bank Board issued the cease and desist order, however, interest-bearing checking accounts were perfectly legal. The Bank Board asserted that its authority to issue the order stemmed from its power to take affirmative action to correct conditions resulting from violations of law or unsafe or unsound practices. The Tenth Circuit, however, disagreed and, in setting aside the Board’s order, held that this power did not allow the Bank Board “to restrict presently lawful conduct in attempting to readjust competitive conditions claimed to have been disturbed by past conduct.”

Following the path laid in Gulf Federal, the decision in Otero Savings & Loan implies that the concept of safety and soundness relates to maintaining

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116 See supra note 97 and accompanying text.

117 Some decisions prior to Gulf Federal, including two Fifth Circuit decisions, upheld the OCC’s finding of unsafe or unsound banking practices even though such practices were not of the magnitude that would immediately threaten the financial integrity of the financial institution. See First Nat’l Bank of Lamarque v. Smith, 610 F.2d 1258, 1264-65 (5th Cir. 1980); Independent Bankers Ass’n of Am. v. Heimann, 613 F.2d 1164, 1168-69 (D.C. Cir. 1979), cert. denied, 449 U.S. 823 (1980); Groos Nat’l Bank v. Comptroller of the Currency, 573 F.2d 889, 896-97 (5th Cir. 1978).

118 665 F.2d 279 (10th Cir. 1981).

119 Id. at 288.

120 Id. at 281-282.


122 Otero Sav. & Loan, 665 F.2d at 286.

123 Id. at 286-87.

124 Id. at 287.

125 Id. at 289.
the financial integrity of a financial institution, rather than providing the federal banking agencies with unlimited power to restrict any otherwise-lawful activities of the institution.  

D. Agencies' Interpretation of Unsafe or Unsound Banking Practices

As discussed above, in the event of judicial review, courts will defer to the agencies' interpretation of the statute. Accordingly, the agencies' interpretation of unsafe or unsound banking practices has special significance. The agencies interpret unsafe or unsound banking practices in the context of enforcement actions, rulemakings, and published agency guidelines. In the enforcement context, the agencies appear to be testing the limits of the safety and soundness definition. More important, the agencies' rulemaking and published guidelines provide some clues as to how the agencies view safety and soundness as a basis for director liability.

1. Interpretation of Unsafe or Unsound in Enforcement Actions

In addition to the evidence that the agencies have strayed from the few circuit court decisions that limit the breadth of the unsafe or unsound banking practices, there is some proof that the agencies have sought to expand the already-broad definition adopted by the courts. For example, citing the language "which might result in abnormal risk or loss" from the judicially adopted definitions, the OCC has indicated that the demonstration of actual loss is not an element of proof in establishing the existence of an unsafe or unsound banking practice.

Moreover, some evidence suggests that the agencies may be advocating a slightly different definition of unsafe or unsound banking practices—one that is arguably broader than the judicially adopted definition. Recall that the judicially adopted definition targets conduct that "might result in abnormal risk or loss." Some administrative orders depart from the "abnormal risk or loss."
risk or loss" language and replace it with "unacceptable risk of loss or damage,"132 "undue risk,"133 "unnecessary risk,"134 or any risk "other than those inherent in doing business, whether in a bank or elsewhere."135

The language "undue risk of loss" has been criticized as substituting a subjective determination of "undue risk" for the "abnormal risk" standard that Congress intended and that the courts adopted.136 Presumably, this objection is based on the premise that the language "abnormal risk" prescribes an objective determination of risk. Yet, it is unclear whether any of these terms (abnormal, unacceptable, undue, unnecessary, or unusual) prescribe either a purely objective or subjective analysis.137

2. Interpretation of Unsafe or Unsound in Rulemaking

From time to time, the agencies have described certain activities that they deem to be unsafe or unsound.138 At the same time, they have asserted consistently that the existence of these regulations does not limit their ability to assert that other activities are also unsafe or unsound.139 This Subsection discusses the most recent and significant agency rulemaking that defines safety and soundness, focusing on the recent proposed rulemaking that provides for the congressionally mandated safety and soundness standards in several important areas of bank operations.

With the passage of FDICIA in 1991, Congress provided the banking agencies with new powers designed to prevent problems in banks' operations or, at a minimum, to resolve problems at the least cost to the deposit insurance fund.140 These new powers operate on what has been described as a "tripwire" system,141 which allows the agencies to take various forms of

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132 See, e.g., Peter M. Fishbein, OTS AP No. 92-24, ¶ 9 (Mar. 11, 1992) (order to cease and desist for affirmative relief from Kaye, Scholer, Fierman, Hays & Handler).


135 Fisher, supra note 86, at 66. The Fed's use of this definition is described by the attorney who argued the case before the D.C. Circuit as one that essentially prohibited "unusual business practices." Id. The court, however, did not reach this issue. Id. at 66 & n.82.

136 Id. at 53.

137 As a practical matter, the determination of risk is bound to be a mixed subjective/objective assessment in which agency examiners utilize both their personal judgment (subjective element) and their knowledge of industry practices (objective element) to determine the level of acceptable risk.

138 The agencies have promulgated some regulations defining certain unsafe or unsound banking practices. See, e.g., 12 C.F.R. § 208.8 (1994) (Fed); 12 C.F.R. §§ 337.1-.11 (1994) (FDIC); 12 C.F.R. § 563.39(a) (1994) (OTS).

139 See 12 C.F.R. § 208.8(o) (1994); 12 C.F.R. § 337.11 (1994).


141 Baxter, supra note 18, at 516-28 (detailing the FDICIA tripwire system).
action once an institution fails to meet defined capital and safety and soundness standards.

Section 132 of FDICIA created a new section 39 of the FDIA and requires each federal banking agency to adopt regulations prescribing standards for safety and soundness in three areas: (1) operations and management, (2) asset quality, earnings, and stock valuation, and (3) employee compensation. If the “appropriate Federal banking agency”


143 See infra notes 144-160 and accompanying text.


145 As codified, § 39(a) of the FDIA provides:

Each appropriate Federal banking agency shall, for all insured depository institutions and depository institution holding companies, prescribe—

(1) standards relating to—
   (A) internal controls, information systems, and internal audit systems, in accordance with section 1831m of this title;
   (B) loan documentation;
   (C) credit underwriting;
   (D) interest rate exposure;
   (E) asset growth; and
   (F) compensation, fees, and benefits, in accordance with subsection (c) of this section; and

(2) such other operational and managerial standards as the agency determines to be appropriate.


146 As codified, § 39(b) of the FDIA provides:

Each appropriate Federal banking agency shall, for all insured depository institutions and depository institution holding companies, prescribe—

(1) standards specifying—
   (A) a maximum ratio of classified assets to capital;
   (B) minimum earnings sufficient to absorb losses without impairing capital; and
   (C) to the extent feasible, a minimum ratio of market value to book value for publicly traded shares of the institution or company; and

(2) such other standards relating to asset quality, earnings, and valuation as the agency determines to be appropriate.


147 As codified, § 39(c) of the FDIA provides:

Each appropriate Federal banking agency shall, for all insured depository institutions, prescribe—

(1) standards prohibiting as an unsafe and unsound practice any employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement that—
   (A) would provide any executive officer, employee, director, or principal shareholder of the institution with excessive compensation, fees or benefits; or
   (B) could lead to material financial loss to the institution;

(2) standards specifying when compensation, fees, or benefits referred to in paragraph (1) are excessive, which shall require the agency to determine whether the amounts are unreasonable or disproportionate to the services actually performed by the individual by considering—
("AFBA") determines that an insured depository institution has failed to meet the prescribed standards, the AFBA will require the institution to submit an acceptable plan specifying the steps that the institution will take to correct the deficiency. If the institution fails to submit an acceptable plan, or materially fails to implement a plan accepted by AFBA, the AFBA must require the institution to correct the deficiency and may take supervisory action against the institution.

Section 39 of the FDIA is intended not to restrict, but rather to augment, any existing authority of the federal banking authorities. Section 39, therefore, does not necessarily affect the formal enforcement powers of the agencies. Nevertheless, these standards should serve as general guidance to the agencies and directors for safe and sound banking practices.

In July 1992, the federal banking agencies published a Joint Advance Notice of Proposed Rulemaking ("ANPR") requesting comments on the issues raised by section 39. The ANPR set forth the agencies’ concerns with regard to these standards:

The overriding issue facing the agencies in adopting regulations pursuant to section 39 of the [FDIA] is how to balance the objectives of the statute relating to safety and soundness standards with the important need to avoid establishing unrealistic and overly burdensome standards that unnecessarily raise costs within the regulated community. In light of the need to attract and retain capital and management talent in the banking and thrift industries, it is important that the standards not needlessly impose uncertainty or raise

(A) the combined value of all cash and noncash benefits provided to the individual;
(B) the compensation history of the individual and other individuals with comparable expertise at the institution;
(C) the financial condition of the institution;
(D) comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the loan portfolio or other assets;
(E) for postemployment benefits, the projected total cost and benefit to the institution;
(F) any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution; and
(G) other factors that the agency determines to be relevant; and

(3) such other standards relating to compensation, fees, and benefits as the agency determines to be appropriate.


148 The "appropriate Federal banking agency" for a national bank is the OCC; for a state member insured bank, it is the Fed; for a state nonmember insured bank, it is the FDIC; and for a savings institution, it is the OTS. 12 U.S.C. § 1813(q) (Supp. V 1993).


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substantive issues with respect to their implementation by the agencies going forward.  

The agencies received over 400 comments and published a Notice of Proposed Rulemaking ("NPR") in November 1993. The NPR reported that commenters strongly preferred general, rather than specific, standards "to avoid regulatory micromanagement of the banking and thrift industries." To a great extent, the agencies accepted this advice and adopted general standards that "establish the ends that proper operations and management shall achieve, while leaving the means to each institution." The proposed standards contain objective criteria with regard to the asset quality and earnings standards. In the area most essential to the duties of bank officers and directors—the operational and managerial standards—however, the proposed standards focus on the content of the bankers' procedures.

153 Id. at 31,337.
155 Id. The majority of the comments came from banks. Id.
156 Id. Professor Baxter, however, warns that the proposed standards' lack of specificity is potentially detrimental to the banking industry:

[T]he generality of these proposed rules, while making the best of a bad situation in the short term, create long-term traps for industry participants insofar as they depend, for their sensible implementation, on agencies that are not subject to the pressure of a Congress that may one day need to react again to a banking crisis such as the one we have just experienced.

Baxter, supra note 89, at 210.

157 For example, highlights of the proposed asset quality and earnings standards for the OCC include:

(a) Maximum ratio of classified assets to capital—

(1) In general. A national bank shall maintain a ratio of classified assets to total capital and ineligible allowances that is no greater than 1.0.

... 

(b) Minimum earnings sufficient to absorb losses without impairing capital. ... A national bank's earnings are sufficient to absorb losses without impairing capital if:

(1) The national bank is in compliance with the minimum capital requirements ... ; and

(2) The national bank would, if its net income or loss over the last four quarters of earnings continued over the next four quarters, remain in compliance with minimum capital requirements.


158 For example, highlights of the proposed operational and managerial standards for the OCC include:

(a) Internal controls and information systems. A national bank shall have internal controls and information systems that are appropriate to the size of the bank and the nature and scope of its activities, and that provide for:

(1) An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to prescribed policies;

... 

(b) Internal audit system. A national bank shall have an internal audit system that is appropriate to the size of the bank and the nature and scope of its activities, and that provides for:

... 

(5) Verification and review of management actions to address identified weaknesses; and
This part of the proposal references, inter alia, internal controls, information systems, internal audit systems, and loan documentation practices.

Although the eventual adoption of the proposed standards does not necessarily affect enforcement against bank directors based on safety and soundness principles,\textsuperscript{159} the operational and managerial standards provide a clue as to how the agencies view the role of management in ensuring banks’ safety and soundness. Not unlike the courts that have applied the business judgment rule in assessing the conduct of directors, the agencies seem to focus

\begin{itemize}
\item[(6)] Review by the national bank’s audit committee or board of directors of the effectiveness of the internal audit system.
\item[(c)] \textit{Loan documentation.} A national bank shall establish and maintain loan documentation practices that:
\begin{itemize}
\item[(1)] Enable the national bank to make an informed lending decision and to assess risk as necessary on an ongoing basis;
\item[(5)] Take account of the size and complexity of a loan;
\end{itemize}
\item[(d)] \textit{Credit underwriting.} A national bank shall establish and maintain prudent credit underwriting practices that:
\begin{itemize}
\item[(1)] Are commensurate with the types of loans the national bank will make
\item[(4)] Establish a system of independent, ongoing credit review with appropriate communication to management and to the board of directors;
\end{itemize}
\item[(e)] \textit{Interest rate exposure.} A national bank shall:
\begin{itemize}
\item[(1)] Manage interest rate risk in a manner that is appropriate to the size of the national bank and the complexity of its assets and liabilities;
\item[(2)] Provide for periodic reporting to management and the board of directors regarding interest rate risk;
\end{itemize}
\item[(f)] \textit{Asset growth.} A national bank’s asset growth shall be based on a plan that:
\begin{itemize}
\item[(1)] Reflects consideration of:
\item[(i)] The source, volatility and use of the funds that support asset growth;
\item[(ii)] Any increase in credit risk or interest rate risk as a result of growth; and
\item[(iii)] The effect of growth on the national bank’s capital;
\end{itemize}
\item[(g)] \textit{Compensation, fees and benefits.} A national bank shall maintain safeguards to prevent the payment of compensation, fees and benefits that are excessive or could lead to material financial loss to the national bank, in accordance with § 30.5 of this part.
\end{itemize}


\textsuperscript{159} The agencies have indicated that their formal enforcement efforts would remain unchanged by § 39 and the proposed regulations. The NPR states also that the proposed regulations change no existing agency policies. See 58 Fed. Reg. 60,802, 60,803 (1993). Moreover, these proposed regulations contain the familiar “savings clause” that reaffirms the gap-filler status of unsafe or unsound banking practices. The notice states:

\begin{quote}
Compliance with the standards required by section 39 would not preclude a finding that an institution is engaged in an unsafe or unsound practice or is in an unsafe or unsound condition. Accordingly, supervisory action may be taken against an institution or company that has not been cited for a deficiency under section 39.
\end{quote}

\textit{Id.; see also supra} note 139 and accompanying text (discussing similar provisions in existing regulations).
their attention on the development of procedures governing banks' operations, rather than mandating particular modes of operation.\textsuperscript{160}

3. **Interpretation of Unsafe or Unsound in Agency Guidelines for Director Liability**

In late 1992, both the FDIC and the OTS issued guidelines regarding the duties of bank officers and directors. These guidelines focus primarily on the duties of care and loyalty but mention also the principles of safety and soundness. Both sets of guidelines contain the following language articulating the duty of care:

The duty of care requires directors and officers to act as prudent and diligent business persons in conducting the affairs of the [institution/bank].

This means that directors are responsible for selecting, monitoring, and evaluating competent management; establishing business strategies and policies; monitoring and assessing the progress of business operations; establishing and monitoring adherence to policies and procedures required by statute, regulation, and principles of safety and soundness; and for making business decisions on the basis of fully informed and meaningful deliberation.\textsuperscript{161}

This language is illuminating for two reasons. First, it evidences the agencies' endorsement of the concepts underlying the business judgment rule by focusing on the directors' duties in the process of running the bank (i.e., hiring competent managers and instituting policies and procedures).\textsuperscript{162} Second, it provides some indication of the agencies' view of where safety and soundness fits within a director's duties: the phrase "principles of safety and soundness" appears within the description of a director's fiduciary duty of care. The agencies indicate that to discharge their duty of care, directors must develop procedures to ensure that their institutions adhere to laws, regulations, and principles of safety and soundness. This language suggests that the agencies view the adherence to principles of safety and soundness as part of directors' fiduciary duty of care.\textsuperscript{163}

**E. Summary**

Taking together congressional intent and court and agency interpretations (and bearing in mind that the agencies may be advocating a broader definition), the definition of unsafe or unsound banking practices includes

\textsuperscript{160} See supra note 158 and accompanying text.

\textsuperscript{161} Statement Concerning the Responsibilities of Directors and Officers of Insured Depository Institutions, OTS 92-163 (Nov. 16, 1992) (emphasis added); New FDIC Guidelines Issued to Clarify the Responsibilities of Bank Directors and Officers, FDIC FIL-87-92 (Dec. 17, 1992) (emphasis added).

\textsuperscript{162} See supra note 65 (discussing the agencies' statements supporting the business judgment rule).

\textsuperscript{163} See also infra notes 198-199 and accompanying text (discussing the agencies' tendency to link unsafe or unsound banking practices and breach of fiduciary duties in formal enforcement actions against directors).
the following elements: (1) conduct deemed contrary to accepted standards of banking operations, and (2) conduct that might result in abnormal risk or loss to a banking institution. The second element requires a showing that the conduct involves at least a potential risk to the bank's solvency. When safety and soundness is viewed in the context of director conduct, evidence suggests that the agencies view the principle as part of a director's fiduciary duty of care.

III. Directors' Safety and Soundness Duty: Application of Unsafe or Unsound Banking Practices as a Basis of Bank Director Liability

Part II of this Article focused on developing a definition of unsafe or unsound banking practices. This Part examines the application of the principle of safety and soundness to the conduct of bank directors. It provides an overview of the statutory foundation for formal enforcement powers based on unsafe or unsound banking practices and highlights the out-of-pocket losses to directors that may result from the exercise of those powers. This Part also catalogs the factual scenarios that typically give rise to formal enforcement actions against directors for violations of safety and soundness.

A. Statutory Basis for Formal Enforcement Powers Based on Unsafe or Unsound Banking Practices

Unsafe or unsound banking practices serve as a basis for director liability under each of the most important formal enforcement provisions: cease and desist orders, civil money penalties, and removal and prohibition. This is not new; unsafe or unsound banking practices have served as a basis for director liability since as early as 1933. This Section discusses the statutory foundation supporting unsafe or unsound banking practices as a basis for each of these formal enforcement proceedings.

The FDIA subjects bank directors to the formal enforcement powers of the federal banking agencies. Under the FDIA, the AFBA has the power to bring various formal enforcement actions against bank directors. The FDIA provides the AFBA with authority to issue a cease and desist order against a bank director if, in the opinion of the AFBA, the director is

164 See infra notes 171-173 and accompanying text.
165 See infra notes 174-180 and accompanying text.
166 See infra note 181 and accompanying text.
167 See supra note 182 and accompanying text.
168 See supra note 42. FIRREA significantly amended the FDIA and expanded the enforcement powers of the federal banking agencies. See supra note 41 and accompanying text.
169 See supra note 148.
170 A bank director is brought under the scope of the various enforcement provisions as an "institution-affiliated party," which includes directors, officers, shareholders, and other professionals (including attorneys). 12 U.S.C. § 1813(u) (Supp. V 1993). The formal enforcement actions described infra notes 171-180 and accompanying text can be brought against any institution-affiliated parties and against the bank itself.
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engaging, has engaged, or is about to engage in an unsafe or unsound banking practice. The AFBA's cease and desist power includes the authority to require directors to make restitution or provide reimbursement, indemnification, or guarantee against loss if the director was unjustly enriched or acted in reckless disregard of the law.

A bank director confronts potential liability for three tiers of civil money penalties. The first-tier penalty may reach up to $5,000 for each day the violation continues, the second-tier penalty may be up to $25,000 per day, and the third-tier penalty may be up to a staggering $1,000,000 per day. The first tier is likely the most potent source of director liability. It includes none of the standards of culpability required in the other two tiers. Although unsafe or unsound banking practices do not serve directly as a basis for the first-tier civil money penalty, directors can be subject to first-tier penalties if they engage in unsafe or unsound banking practices and then violate the terms of a cease and desist order issued in response to such practices.

A bank director is liable for a second-tier civil money penalty of up to $25,000 per day for recklessly engaging in an unsafe or unsound practice if such practice (1) is part of a pattern of misconduct, (2) causes or is likely to cause more than minimal loss to the bank, or (3) results in pecuniary gain or other benefit to the director. Third-tier civil money penalties of up to $1,000,000 per day may be imposed on a director who knowingly engages in any unsafe or unsound practice and either knowingly or recklessly causes a substantial loss to the bank or receives a substantial pecuniary gain or other benefit by reason of such practice.

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176 See infra notes 179-180 and accompanying text (discussing the statutory requirements for second-tier and third-tier civil money penalties).

177 The first-tier civil money penalty may be assessed for a violation of any law, regulation, or any provision imposed by a cease and desist order. The penalty is up to “$5,000 for each day during which such violation continues.” 12 U.S.C. § 1818(i)(2)(A) (Supp. V 1993).

178 A violation of any final order issued pursuant to 12 U.S.C. § 1818(b) (cease and desist provisions) serves as a basis for first-tier civil money penalty. 12 U.S.C. § 1818(i)(2)(A)(ii) (Supp. V 1993). There is no requirement of a finding that the violation of the final order was intentional, knowing, reckless, or even negligent.

179 12 U.S.C. § 1818(i)(2)(B) (Supp. V 1993). Breach of the director's fiduciary duty serves also as a basis for a second-tier civil money penalty if the breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss to the bank, or results in a pecuniary gain or other benefit to the director. Id.

180 12 U.S.C. § 1818(i)(2)(C) (Supp. V 1993). A director may also be subject to a third-tier civil money penalty for knowingly breaching any fiduciary duty and either knowingly or recklessly causing a substantial loss to the bank or a substantial pecuniary gain or benefit to the director by reason of breach. Id.
Finally, the agencies' enforcement powers include the authority to remove a bank director from office and to prohibit the director from participating in the affairs of the bank, if the AFBA determines that (1) the director engaged or participated in any unsafe or unsound practice; and (2) by reason of such practice, the bank suffered or will probably suffer financial loss or other damage, or the interests of the bank's depositors have been or could be prejudiced, or the director has received financial gain or other benefit; and (3) the practice involved personal dishonesty or demonstrated willful or continuing disregard by the director for the safety or soundness of the bank.  

Directors may appeal the exercise of these agency enforcement powers to the appropriate United States court of appeals. This appellate review is governed by the Administrative Procedure Act ("APA"), which provides that agency action will be reversed only upon a court's finding that the action was not supported by substantial evidence or is otherwise arbitrary and capricious. Directors seeking recourse in appellate courts face an uphill battle given the deference enjoyed by the regulators under the APA.

B. Directors' Monetary Exposure in Formal Enforcement Actions

As is evident from the preceding discussion, the agencies' exercise of their formal enforcement powers can lead to the imposition of both monetary damages (authorized as part of the agencies' cease and desist powers) and civil money penalties. Despite the existence of insurance policies and corporate indemnification, directors may be required to pay these damages and penalties out of their own pockets.

Directors' and officers' liability insurance policies often include a "regulatory exclusion" clause that excludes from coverage any actions brought by the banking regulators. Because these exclusionary clauses have been generally enforced, directors are not likely to be insured against personal monetary liability stemming from formal enforcement actions.

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184 5 U.S.C. § 706 (1988); see Sunshine State Bank v. FDIC, 783 F.2d 1580, 1584 (11th Cir. 1986) (per curiam) (citing 5 U.S.C.A. § 706(2)(A) in reviewing FDIC enforcement action); First Nat'l Bank of Eden v. Department of the Treasury, 568 F.2d 610, 611 (8th Cir. 1978) (per curiam) (citing 5 U.S.C. § 706(2)(E) in reviewing OCC enforcement action); see also First Nat'l Bank of Lamarque v. Smith, 610 F.2d 1258, 1264 (5th Cir. 1980) (stating that "[t]he [OCC] has wide discretion in the field of national banking and the exercise of [its] discretion will not be disturbed except when the exercise is arbitrary, capricious or contrary to law").

185 See supra notes 171-180 and accompanying text.

186 Not only do the "regulatory exclusion" clauses exclude coverage for formal enforcement actions brought by the regulators, but they also exclude insurance coverage in receivership cases brought by the FDIC and RTC.

187 See, e.g., FDIC v. American Casualty Co., 995 F.2d 471, 472-73 (4th Cir.), amended, No. 92-1447 (4th Cir. May 6, 1993); Fidelity & Deposit Co. v. Conner, 973 F.2d 1236, 1243-44 (5th
Most banks, through their charters or by contract, offer indemnification to their officers and directors for all losses and expenses incurred by reason of their service. Corporate indemnification may prove useless in receivership actions (because the bank is insolvent). If a bank is solvent, corporate indemnification may be available to satisfy damage awards and civil money penalties.\footnote{FDIA section 1828(k), however, provides the FDIC with the authority to prohibit or limit indemnification payments.} As part of their negotiated settlements of formal enforcement actions, agencies often prohibit indemnification of civil money penalties and expenses.\footnote{Accordingly, the usefulness of corporate indemnification to directors is limited.} C.

Formal Enforcement Actions Against Directors for Unsafe or Unsound Banking Practices

1. Examiners’ Roles in the Formal Enforcement Process

The process that eventually leads to a formal enforcement action against a director begins with the appropriate agency’s safety and soundness examination of the bank. Agency examiners play an important role in this process. They determine whether the bank or its institution-affiliated parties have committed unsafe or unsound banking practices.\footnote{These same examiners may later serve as expert witnesses in administrative proceedings. Moreover, when reviewing loan classifications, courts, administrative law judges, and the agencies (in their adjudicative role) defer to the examiners’ determination. In reviewing agency decisions, courts must defer to the decision of the agency unless it is not supported by substantial evidence or is otherwise arbitrary and capricious.} Courts have held that bank examiners may serve as expert witnesses in administrative proceedings on the issue of what constitutes unsafe or unsound practices. See Sunshine State Bank v. FDIC, 783 F.2d 1580, 1583 (11th Cir. 1986) (per curiam); First Nat’l Bank of Eden v. Department of the Treasury, 568 F.2d 610, 611 (8th Cir. 1978) (per curiam).}
With these layers of deference as a backdrop, the next two Sections discuss common categories of cases in which unsafe or unsound banking practices give rise to formal enforcement actions against bank directors. The first category includes those cases in which the bank’s unsafe or unsound banking practices are the basis for a cease and desist order that is binding against the bank and its institution-affiliated parties. The second category includes cases in which the directors’ conduct forms the basis for formal enforcement actions.

2. Actions Based Upon Banks’ Practices

Although the scope of this Article is limited to directors’ unsafe or unsound banking practices, in many cases directors are held indirectly liable for the banks’ unsafe or unsound banking practices. Because these cases do not name individual directors as respondents, they do not typically include specific findings relating to individual directors’ conduct. It is appropriate, then, that the liability of directors in this class of cases be limited to the imposition of a cease and desist order that is binding on the bank and all institution-affiliated parties.

These cases involve most often a laundry list of practices that constitute unsafe or unsound banking practices. In a recent typical enforcement action, the FDIC found that the bank had engaged in the following unsafe or unsound banking practices: operating the bank with an excessive volume of adversely classified loans; engaging in hazardous lending and lax collection practices; operating with unsatisfactory earnings; and failing to have an adequate allowance for loan and lease losses. Although this action did not name officers or directors as respondents, the unsafe or unsound banking practices identified included operating with poor management.

195 The information in the next Subsection should be considered with three points in mind. First, the information contained therein is derived primarily from adjudicated cases because such cases tend to have more complete and formal records. Because the vast majority of formal enforcement actions are settled, this Subsection provides only some indication of how the agencies apply unsafe or unsound banking practices; it cannot give the complete picture. Second, my research focused on directors as respondents in formal enforcement actions. Because in most of these cases respondents were both directors and officers and because the FDIA treats officers and directors alike for purposes of their liability in formal enforcement actions (as both are institution-affiliated parties), these cases do not typically distinguish between the respondent’s conduct as an officer and the respondent’s conduct as a director. Third, most safety and soundness cases involve allegations of violations of law or regulation as well as unsafe or unsound banking practices. Therefore, the conduct giving rise to an unsafe or unsound banking practice may give rise also to a violation of law or regulation. Cases in which the only basis for the unsafe or unsound banking practices is a violation of law or regulation, however, have been excluded.


3. *Actions Based Upon Directors' Conduct*

In those cases in which the directors are respondents, examples of the conduct that may involve unsafe or unsound banking practices include transactions with affiliates; failure to disclose conflicts of interest to other board members; compensation practices; other self-dealing transactions; and transactions leading to false bank records. These practices often give rise also to a finding that the directors breached their fiduciary duty to the bank.\(^\text{198}\) This comes as no surprise as these practices often resemble cases involving a review of business judgments (governed by the fiduciary duty of care) or transactions involving self-dealing (governed by the fiduciary duty of loyalty).\(^\text{199}\)

The OTS recently issued a Notice of Charges in a case alleging that a director's involvement in certain transactions with bank affiliates was an unsafe or unsound banking practice and a breach of his fiduciary duties.\(^\text{200}\) The OTS charges that the respondent, the former director of American Savings and Loan Association of Florida ("American"), failed to take steps to protect the interests of American in the implementation of a collateral substitution


\(^{199}\) Many of the adjudicated cases against directors involve facts relating to a director's duty of loyalty. See supra note 27 (discussing the duty of loyalty). One reason for this is that the statutory provisions providing for many of the formal enforcement powers require findings of culpability that relate to the duty of loyalty apart from the finding of unsafe or unsound banking practices. For example, if an agency brings a removal action against a director based on a finding of an unsafe or unsound banking practice, the agency must find also that the practice involved "personal dishonesty" or "demonstrate[d] willful or continuing disregard by [the director] for the safety or soundness" of the bank. 12 U.S.C. § 1818(e)(1)(C) (Supp. V 1993). A finding of "personal dishonesty" likely would involve self-dealing that would constitute a breach of the duty of loyalty. Similarly, if an agency seeks restitution from a director based on unsafe or unsound banking practices, the agency must find also that the director was enriched unjustly or that the practice involved reckless disregard for the law. 12 U.S.C. § 1818(b)(6)(A) (Supp. V 1993). A finding of "unjust enrichment" likely would involve a breach of the duty of loyalty. By contrast, the agencies' cease and desist power can be used against a director solely on a finding of unsafe or unsound banking practices. See infra note 246 and accompanying text.

\(^{200}\) Donald M. Kaplan, OTS Order No. AP 94-11, slip op. at 13-15 (Mar. 11, 1994) (Notice of Charges). At the time this Article went to press, this matter remained unadjudicated.
American was owned by Enstar Group, Inc. ("Enstar"), a savings and loan holding company that also owned Enstar Specialty Retail, Inc. ("Enstar Retail"). Under the collateral substitution plan, the common stock of Enstar Retail was pledged to American in exchange for cash generated by the sale of junk bonds securing a $209,258,795 note held by American.

Because the respondent attended the meeting in which Enstar approved the plan, the Notice alleges that the respondent knew that the collateral substitution plan posed an abnormal risk of loss to American and that the respondent failed to take steps to protect American's interests (e.g., he failed to advise, or seek approval from, American's board of directors regarding the plan). The OTS alleges that this conduct constitutes an unsafe or unsound banking practice as well as a breach of fiduciary duty. The OTS notice asks for restitution in the amount of $18,333,180 plus interest and seeks to prohibit the respondent from participating in the affairs of any bank.

One highly publicized action provides an excellent example of a situation in which a breach of fiduciary duty (involving conflicts of interest) served as a basis for a finding of an unsafe or unsound banking practice. In Neil M. Bush, the OTS found that savings and loan director Neil M. Bush, son of then-President George Bush, had engaged in an unsafe or unsound banking practice by breaching his fiduciary duty to Silverado Banking, Savings and Loan Association. The OTS found that Mr. Bush failed to disclose his financial interest to other board members in certain loan and real estate transactions being considered by the Silverado board.

In reaching its decision, the OTS applied a two-prong definition of safety and soundness. First, the OTS considered whether the conduct was contrary to generally accepted standards of prudent operation of a financial institution. The OTS concluded that a breach of fiduciary duty by failing to disclose a conflict of interest is clearly contrary to those standards. Second, the OTS considered whether the conduct, if continued, might be an abnormal risk or loss or damage to the institution, its shareholders, or the insurance fund. It concluded that by breaching his fiduciary duty, Bush had exposed the savings and loan to the possibility of abnormal risk because his conduct had "impaired the decision-making process of the board [of directors]."

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201 Id. at 4, 9-13.
204 Id. at 13-15. The Notice of Charges also includes allegations that Kaplan violated certain laws and regulations. Id. at 13.
205 Id. at 15.
207 Id. at *2-*3.
208 Id. at *35-*36.
The agencies have not always been successful in asserting conflicts of interest as a basis for a finding of unsafe or unsound banking practices. In *In re Seidman*, the Third Circuit reversed a finding by the OTS that a director's conflicts of interest constituted an unsafe or unsound banking practice. Seidman was the chairman of the board at Crestmont Federal Savings and Loan ("Crestmont"). The OTS alleged, *inter alia*, that Seidman had engaged in unsafe or unsound banking practices by using his position at Crestmont to obtain a release from his personal guaranty of a loan made by another financial institution to Fulton Street Associates ("FSA"). FSA was a real estate partnership formed by Seidman and several others to purchase and develop industrial condominiums. FSA was interested in negotiating end-user financing with Crestmont. Seidman believed he would have to relinquish his interests in FSA for Crestmont to consider end-user loans; therefore, he sought a release of his personal guaranty of FSA's loan obligations and withdrew from FSA. Although Crestmont never made any end-user loans, the Director of the OTS concluded that Seidman's pursuit of a release from his personal guaranty was an unsafe or unsound banking practice. The Third Circuit found that the record did not support the conclusion that Seidman's conduct with respect to his personal guaranty was contrary to accepted banking practices. Alternatively, the court reasoned that even if it were to accept that Seidman's conduct was imprudent, the OTS had failed to show that the conduct created an abnormal risk of financial loss to Crestmont.

Compensation practices and other payment schemes may also constitute unsafe or unsound banking practices. For example, in one Ninth Circuit case, the court reviewed the FDIC's issuance of a cease and desist order that directed Harold A. Hoffman, president of Alaska Continental Bank, to repay almost $62,000 that he had received in a buyout of his employment contract with the bank. The Ninth Circuit agreed with the FDIC's finding that given the condition of the bank, this transaction was an unsafe or unsound banking practice. Rejecting the director's argument that he should have been allowed to show that the bank was not insolvent at the time of the payment, the Ninth Circuit stated:

210 *In re Seidman*, 37 F.3d 911, 915-16 (3d Cir. 1994).
211 *Id.* at 921-22.
212 *Id.* at 917. The court explained that
   end-user financing permits a person who plans to occupy a unit in a development
to buy the unit or rent it to others. The institution that has financed the project has
a strong interest in facilitating end-user financing because it usually receives a sub-
stantial part of the price the end-user pays, thus reducing its exposure on the loan
to the developer.

213 *Id.* at 919-20.
214 *Id.* at 915-16.
215 *Id.* at 933.
216 *Id.* The court found, however, that Seidman's attempts to obstruct the OTS's investigation constituted an unsafe or unsound banking practice. *See infra* note 222 and accompanying text.
217 Hoffman v. FDIC, 912 F.2d 1172, 1173 (9th Cir. 1990).
218 *Id.* at 1174.
Whether, as it ultimately turned out, the bank was insolvent or not, it was most apparent that its assets must be preserved. Given that, it was hardly prudent to decide that the best thing for [the bank] and its assets was to buy out [the director's] contract, because he had decided to abandon a rapidly sinking ship.\textsuperscript{219}

In addition, other similarly abusive self-dealing transactions, such as check-kiting schemes,\textsuperscript{220} kickback schemes,\textsuperscript{221} attempts to obstruct an agency investigation,\textsuperscript{222} and other payments to third parties for the ultimate benefit of respondent-directors,\textsuperscript{223} constitute unsafe or unsound banking practices. Finally, the agencies have targeted director conduct affecting the accuracy of banks' financial statements, such as issuing bank stock in exchange for funds that have not been received by the bank.\textsuperscript{224}

\textsuperscript{219} Id. at 1175; see also Simpson v. OTS, 29 F.3d 1418, 1425-26 (9th Cir. 1994) (holding that given the institution's financial condition, the president and chairman of the board improperly distributed profits to himself and other officers and managers); Jameson v. FDIC, 931 F.2d 290, 291 (5th Cir. 1991) (per curiam) (holding that a former bank officer improperly falsified bank records to conceal his bonus from other bank officials); FSLIC v. Bass, 576 F. Supp. 848, 852 (N.D. Ill. 1983) (mem.) (holding that employment agreements providing large bonuses to officers and directors of a savings and loan were unsafe or unsound banking practices); ***, in 1 FDIC ENFORCEMENT DECISIONS AND ORDERS ¶ 5003, at A-30 (Arthur L. Beamon & Nancy L. Alper eds., Supp. 1992) (holding that a payment of a management fee of $276,300, given the bank's poor condition, was unsafe or unsound); James L. Magee, No. 91-024-E II, slip op. at 18-25 (Bd. of Governors of the Fed. Reserve Sys. Oct. 5, 1992) (Final Decision and Order) (holding that a bank director improperly paid himself hundreds of thousands of dollars in excess of salary and bonus from the bank's miscellaneous expense account); Notice of Assessment of Civil Money Penalties to Gilbert D. Hill, OCC EA No. 582, 1991 OCC Enf. Dec. LEXIS 345, at *1 (Apr. 16, 1991) (ordering penalties for "unreasonable salaries or other benefits paid to" the bank's chairman). \textit{But see} Ernest P. Pettinari, [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 89,304, at 82,613 (Nov. 17, 1992) (holding that officers of troubled institution did not engage in unsafe or unsound banking practices by accepting severance payments deposited in an escrow account and drawn on the day the bank was closed).

\textsuperscript{220} See Van Dyke v. Board of Governors of the Fed. Reserve Sys., 876 F.2d 1377, 1380 (8th Cir. 1989) (holding check-kiting to be an unsafe or unsound banking practice).

\textsuperscript{221} See Richard M. Roberson, No. FDIC-92-122e, 1994 FDIC Enf. Dec. LEXIS 47, at *5 (Feb. 22, 1994) (holding former director and executive vice president's receipt of $300,000 in kickbacks through nominee borrower transactions to be an unsafe or unsound practice).

\textsuperscript{222} See \textit{In re} Seidman, 37 F.3d 911, 936-37 (3d Cir. 1994).

\textsuperscript{223} See Richard A. Palmer, No. FDIC-90-156c&b, 1991 FDIC Enf. Dec. LEXIS 214, at *14 (Sept. 17, 1991) (holding president and director's authorized prepayment of legal fees for his own benefit when he had notice that the bank was insolvent to be an unsafe or unsound practice); EVCO, Inc., No. 87-033-CMP-HC, slip op. at 13-18 (Bd. of Governors of the Fed. Reserve Sys. Jan. 26, 1990) (final decision) (holding numerous practices, including payment of consulting fees to entities related to directors, to be unsafe or unsound).

IV. Comparison of the Theoretical Foundations for Unsafe or Unsound Banking Practices and Breach of Fiduciary Duty of Care

As discussed in Part II, some evidence suggests that the agencies view principles of safety and soundness as part of a director’s fiduciary duties. Part III indicated that many of the safety and soundness cases brought against bank directors include claims that directors breached their fiduciary duties and suggested that the types of cases that give rise to allegations of unsafe or unsound banking practices give rise also to allegations of breach of fiduciary duty. To resolve these connections, this Part compares the principles of safety and soundness with the principles underlying a director’s fiduciary duty of care and concludes that, although the principles are not equivalent, they are closely related—each having a theoretical basis in negligence theory.

A. Similarities Between Unsafe or Unsound Banking Practices and Breach of Fiduciary Duty

As discussed in Part I, bank directors must exercise ordinary care in the administration of the affairs of their banks.225 The duty of ordinary care, sometimes called the fiduciary duty of care,226 has its basis in negligence theory.227 Negligence is “conduct which falls below the standard established by law for the protection of others against unreasonable risk of harm.”228 In comparison, unsafe or unsound banking practices means “conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder.”229 These definitions are similar in that they both refer to conduct that falls below a normative standard and involves an abnormal or unreasonable risk of harm.

If an unsafe or unsound banking practice is essentially the same as a failure to exercise ordinary care, directors’ unsafe or unsound banking practices must involve some form of negligence—be it simple or gross negligence. Although the cases involving unsafe or unsound banking practices do not

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225 See supra part I.A.
226 See supra note 27 (explaining the confusion surrounding the use of the term “fiduciary”).
227 See supra note 46.
228 Restatement (Second) of Torts § 282 (1964). The negligence standard established by law is the “reasonable man” standard. Id. § 283. (One assumes that a Restatement (Third) will incorporate the “reasonable person” standard—we have come a long way since 1964.)
229 See supra text accompanying note 91.
necessarily contain a finding of negligence, the facts of the cases would generally support such a finding. Accordingly, many of the cases involving directors' unsafe or unsound banking practices involve also claims that the directors breached their fiduciary duties.

B. Differences Between Unsafe or Unsound Banking Practices and Breach of Fiduciary Duty

Although the discussion above emphasizes the similarities between unsafe or unsound banking practices and the breach of fiduciary duty, the two concepts are not equivalent. First, in all likelihood, Congress did not intend to equate unsafe or unsound banking practices with breach of fiduciary duty because a breach of fiduciary duty serves as a separate basis for liability for each of the formal enforcement provisions except the cease and desist order.

One bank raised a comparable objection in defense of a cease and desist action brought by the FDIC. In re Seidman, 37 F.3d 911, 932 n.30 (3d Cir. 1994) (noting that “Congress obviously thought the concepts were distinct enough to require separate specification in” the law). Note that Congress's intent is the key to determining the meaning of unsafe or unsound banking practices, whereas the common law is the source of the interpretation of fiduciary duty. Professor Baxter illuminated this distinction:

It is important, when noting the flexibility inherent in the “unsafe and unsound” concept, to emphasize that this flexibility is not identical to that stemming from the equitable nature of fiduciary duties. In the case of fiduciary duties, their content is ultimately determined by a supervising court that, as the exponent of equitable doctrine, wields the initiative in reaching final determinations concerning the application of such doctrine in individual cases. In the case of safety/soundness principles, the primary reference point is the intention of Congress; the question facing a court is not whether it (the court) regards an action or condition as unsafe and unsound, but whether the agency, given its statutory authority, has correctly concluded that it is. The actual limits of agency authority in each case will depend upon a matrix of legislative prescripts that will usually reflect carefully crafted congressional compromises. Congress frequently prescribes detailed safety/soundness principles; when an agency imposes requirements that reach beyond these principles and is struck down by a court on review, the agency must return to Congress to gain the additional authority it needs. In the case of a fiduciary duty, on the other

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230 The same cannot be said for the cases discussed supra part III.C.2, in which directors were held indirectly liable for the bank's unsafe or unsound banking practices. Such cases typically involve a laundry list of alleged practices. Although some might support a finding of negligence (e.g., lax lending practices), others might not necessarily support a finding of negligence (e.g., operating with unsatisfactory earnings). In fact, a finding that a bank is operating with unsatisfactory earnings does not appear to be focused on conduct. Rather, it appears to describe the harm that might result from mismanagement of the bank. It is similar to saying that a broken leg is negligent. A broken leg is not negligent; leaving a banana peel in the middle of the floor is negligent.

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power. For example, if Congress viewed unsafe or unsound banking practices as equivalent to a breach of fiduciary duty, then Congress would not have included both principles as bases for the agencies’ power to remove directors from office.

Second, not every breach of fiduciary duty constitutes an unsafe or unsound banking practice. Recall that the principle of safety and soundness is intended to protect a bank’s financial integrity. Not all negligent conduct puts such integrity at risk. For example, if a director is responsible for allowing a bank to make a loan to a borrower who the director knows or should know is not creditworthy, the bank director’s conduct is negligent. If the conduct poses a potential risk to the bank’s financial integrity, then the conduct quite likely would constitute also an unsafe or unsound banking practice. Yet if the loan made was for a nominal sum and was not part of any pattern of conduct by the director, then the loan would not constitute an unsafe or unsound banking practice.

C. Assessment of the Comparison Between the Unsafe or Unsound Banking Practices and Breach of Fiduciary Duty

Although Congress did not intend directors’ unsafe or unsound banking practices to be equivalent to a breach of fiduciary duty, the two principles have almost identical theoretical bases, i.e., both principles have negligence-theory underpinnings. The differences between the two principles, however, suggest that unsafe or unsound banking practices is in some ways a narrower and in some ways a broader principle than breach of fiduciary duty.

Because Congress intended the concept of unsafe or unsound banking practices to address banks’ risk of insolvency, the loss that might result from such practices must relate to that risk. The same cannot be said for breach of fiduciary duty: a breach of fiduciary duty need not be tied to any risk of hand, the delegation of power to a court and, in practice, to the agency is much fuller. The distinction is, therefore, not merely semantic. Baxter, supra note 28, at 24-25 (footnotes omitted).

See supra part III.A (discussing the statutory basis for the formal enforcement powers).

The Third Circuit recently observed: “While the same act may be both an unsafe or unsound practice under § 1818(e)(1)(A)(ii) and a breach of a fiduciary duty under § 1818(e)(1)(A)(iii), we hesitate to make one a proxy for the other.” Seidman, 37 F.3d at 932.


See supra notes 102-117 and accompanying text.

For a claim of negligence to be actionable, the plaintiff must prove that he suffered a legally cognizable injury compensable by damages. See Restatement (Second) of Torts § 328A(d) (1964).

For example, in a final decision by the FDIC to remove an officer/director from office that was based, in part, on lending and collection practices constituting unsafe or unsound banking practices, the FDIC made specific findings that the respondent had deviated from “normal and acceptable lending practices.” *** Bank of *** County, ***, in 1 FDIC Enforcement Decisions and Orders ¶ 5042, at A-379 (Arthur L. Beamon & Nancy L. Alper eds., Supp. 1992). These findings likely would support also a finding that the respondent was negligent.

See Paul E. Oberstar, No. FDIC-91-19E, 1991 FDIC Enf. Dec. LEXIS 408, at *13 (Aug. 2, 1991) (stating that “for a onetime event to be found an unsafe or unsound practice, there must be some showing that harm could reasonably result from that act”).

See supra notes 102-117 and accompanying text.
insolvency to be actionable. Moreover, a finding of unsafe or unsound banking practices does not require proof of actual loss; it requires only proof that the practices might result in a loss.\textsuperscript{240} For a breach of fiduciary duty to be actionable, however, the plaintiff would have to prove some actual, rather than predictive, loss.\textsuperscript{241}

V. Reconciling the Safety and Soundness Duty and Fiduciary Duty

Based on the conclusion drawn in Part IV that both unsafe or unsound banking practices (when applied to director conduct) and the fiduciary duty of care share the same theoretical basis, this Part seeks to reconcile the differences between formal enforcement actions based on unsafe or unsound banking practices and receivership actions based on breach of fiduciary duty. Because both actions have negligence as their underpinning, the application of the principles associated with each cause of action should produce similar results and, in effect, create the same types of obligations. This Part concludes that, in application, principles of safety and soundness can create a higher standard of care than that required to discharge directors' fiduciary duty of care. It finds that in many cases, the inconsistency between the application of these two concepts is eliminated by statutory culpability requirements separate from unsafe or unsound banking practices. Finally, this Part concludes that the agencies should adopt enforcement policies to resolve any remaining inconsistencies.

A. Comparing the Discharge of Fiduciary Duty and the Discharge of the Safety and Soundness Duty

Because the courts recognize the difficulty in reviewing business judgments, they defer to directors' decisions under the business judgment rule and focus their inquiry on the process of making those decisions.\textsuperscript{242} Similar to fiduciary duty cases, safety and soundness cases involve a review of the same type of conduct—the business judgments of directors. The business judgment rule, however, arises under state law and thus will not be applied in cases reviewing the agencies' formal enforcement actions because enforcement actions arise under federal law. Furthermore, in formal enforcement actions, courts defer to agency findings, overturning only those found to be arbitrary and capricious.\textsuperscript{243}

For these reasons, although both the receivership and formal enforcement actions involve a review of the same conduct, in the former, courts will defer to the directors' judgments, while in the latter, courts will defer to the agencies' judgments. In essence, directors are held to a higher standard of care in the formal enforcement context than in the receivership context. The following discussion assesses the justifications for this fundamental difference in the treatment of director conduct.\textsuperscript{244}

\textsuperscript{240} See supra note 97 and accompanying text.

\textsuperscript{241} See supra note 236.

\textsuperscript{242} See supra part I.C.

\textsuperscript{243} See supra notes 182-184 and accompanying text.

\textsuperscript{244} The business judgment rule and the policy justifications supporting the rule have been
B. Assessing the Justifications for the Creation of a Higher Standard of Care

1. Statutory Culpability Requirements

Except for the cease and desist power, all of the formal enforcement provisions discussed herein require a finding of culpability such as "knowing" or "reckless" conduct, in addition to the finding of an unsafe or unsound banking practice. In many instances, therefore, a formal enforcement action will not involve the imposition of a higher standard of care due to these separate culpability requirements. The agencies' cease and desist power, however, does not contain similar culpability requirements and can be invoked on the sole finding of an unsafe or unsound banking practice. Accordingly, directors may be held to a higher standard of care in a cease and desist proceeding than in a receivership action.

This disparity can be justified perhaps by the differences in the sanctions imposed, i.e., the imposition of a cease and desist order versus a judgment for monetary damages. Although the cease and desist order is a public document and may cause a degree of public disgrace, it does not impose the same hardship on a director as does a judgment for monetary damages. The imposition of a cease and desist order, however, can serve as the basis for harsher sanctions.

Assume, for example, that one of the agencies finds that a bank and its board of directors have engaged in unsafe or unsound banking practices. The agency issues (most likely with the consent of the bank and the board) a cease and desist order. The order requires, among other things, the board to increase the bank's capital to a particular percentage of the bank's total assets within 90 days. A breach of this cease and desist order, even if the directors acted with all due diligence to bring the bank's capital to the desired level, could lead to an assessment of civil money penalties of up to $5,000 per day against the bank. If it takes the board 190 days to increase the bank's capital, it could be questioned on various grounds. See Balotti & Hanks, supra note 55, at 1341-44 (evaluating the bases for the rule); Gevurtz, supra note 55, at 289 (noting that the rule's rationales "fail to justify a differentiation between directors and other prospective tort defendants who can and do assert similar arguments for more lenient treatment"). Given that the law grants special treatment to business judgments in state law negligence actions, the question remains whether the law should grant the same treatment to business judgments that are the subject of formal enforcement actions.


247 The agencies' cease and desist power includes the power to collect monetary awards, but only if the respondent was unjustly enriched or acted with reckless disregard for the law. 12 U.S.C. § 1818(b)(6)(A) (Supp. V 1993).

248 See supra part III.B (discussing directors' monetary exposure).

249 A first-tier civil money penalty is available based on the violation of any final order.
capital to the required level, the directors are each potentially liable for $500,000 in civil penalties.\footnote{250}

A $500,000 penalty hurts the director no more or less than would a judgment in a receivership action for $500,000 in damages.\footnote{251} Yet, the types of business judgments that may lead to unsafe or unsound practices do not differ fundamentally from the types of business judgments reviewed in suits alleging breach of fiduciary duty.

For these reasons, the statutory culpability provisions provided by Congress for use in the formal enforcement context compensate partially for what would otherwise be an imbalance in the standards of care applied to directors in agency-initiated cases. The potential for imposing civil money penalties, however, is troublesome, particularly in the light of the agencies' routine practice of issuing cease and desist orders against directors and other institution-affiliated parties without specific findings of any individual director's wrongdoing. As a result, directors are forced to rely on the fair-mindedness of the agencies and hope that no external forces will force the agencies to exercise the outer limits of their powers.

2. Expertise of the Agencies

Because differences in sanctions do not justify fully the differences in reviewing business judgments, a comparison of the rationale for the deference given to the agencies in formal enforcement actions versus the rationale for the deference given to directors' judgments in receivership cases may assist in reconciling the disparities.

The rationale for deference enjoyed by directors in receivership cases (through the operation of the business judgment rule) is that the courts should refrain from second-guessing business judgments. Directors would likely favor the passage of a statute that imposed the business judgment rule on agencies' adjudication of actions alleging directors' unsafe or unsound banking practices. Arguably, however, the business judgment rule does not have a place in formal enforcement actions because the potential harm addressed by the business judgment rule (second-guessing of directors' decisions) is not apparent when the adjudicator is a federal banking agency with

\footnote{250} This example does not intend to suggest that the agencies act, or will act, in bad faith or with poor judgment in enforcing the principles of safety and soundness. Rather, the presumption is that agency officials perform their duties fairly and in good faith. See Alaska Airlines, Inc. v. Johnson, 8 F.3d 791, 795 (Fed. Cir. 1993). Still, to the extent that Congress has given the agencies a power that is, as argued here, excessively broad, Congress and other external forces (such as public opinion or the press) may force the agencies to use that power to its fullest extent. Professor Baxter has commented that "one cannot help but wonder whether the agencies will be able to remain moderate in their deployment of the powers prescribed by section 39 [of the FDIA] if economic and political circumstances deteriorate." Baxter, supra note 89, at 219. Professor Baxter's comment relates to FDICIA's safety and soundness standards discussed in Part II.D.2 of this Article.

\footnote{251} Director and officer insurance policies and corporate indemnification will be of little help. See supra part III.B.
expertise in reviewing the judgments of bank directors. This argument, however, assumes that the agencies are experts in reviewing business judgments.252

The United States General Accounting Office ("GAO") has criticized the agencies' applications of safety and soundness principles. The GAO found inconsistent conclusions regarding safety and soundness (e.g., the FDIC and OTS arrived at conflicting conclusions after examinations of the same institution conducted within three months of each other),253 inadequate quality control of the examinations,254 reliance on insufficient evidence (e.g., using outdated and incomplete data),255 and lack of specific guidance for examiners.256

Such criticisms, although significant, do not lead to the conclusion that courts should never defer to the agencies in cases alleging unsafe or unsound banking practices. Under the APA, courts must defer to the agencies, unless the agencies' findings are not supported by substantial evidence.257 Nevertheless, these criticisms do support the conclusion that courts should refuse to extend the deference that is afforded to the agencies beyond the APA's substantial evidence standard for review of agency actions.258

252 Because this Article focuses on the gap-filling functions of principles of safety and soundness, the safety and soundness determinations discussed herein involve the highly discretionary area of the business of banking that is not amenable to specific regulation. Given the complexities and constant changes in the banking industry, it is perhaps unrealistic to expect that the agencies will always have actual expertise in areas governed by principles of safety and soundness.

253 Thrift Examination Quality: OTS Examinations Do Not Fully Assess Thrift Safety and Soundness, GAO AFMD-93-11, at 36 (Feb. 16, 1993). The GAO concluded that the inconsistency between the agencies' findings "confuses thrift management and undermines the credibility of the regulatory process." Id.

254 See Bank Examination Quality: FDIC Examinations Do Not Fully Assess Bank Safety and Soundness, GAO AFMD-93-12, at 46-52 (Feb. 16, 1993). The GAO found that "working papers were not prepared in a manner that enabled independent reviewers to clearly judge the competency and sufficiency of work performed by examiners." Id. at 49; see also Bank Examination Quality: FRB Examinations and Inspections Do Not Fully Assess Bank Safety and Soundness, GAO AFMD-93-13, at 38-39 (Feb. 16, 1993) (finding that Fed examinations did not use consistent methodology); Bank Examination Quality: OCC Examinations Do Not Fully Assess Bank Safety and Soundness, GAO AFMD-93-14, at 37-38 (Feb. 16, 1993) (finding quality controls inconsistent in OCC examinations).

255 See Bank Examination Quality: FDIC Examinations Do Not Fully Assess Bank Safety and Soundness, GAO AFMD-93-12, at 18-20 (Feb. 16, 1993) ("Information needed to assess loan quality was either missing, incomplete, outdated (over 1 year old), or unverified.").

256 See id. at 20-22 (noting that examiners lack guidance on procedures for evaluating loan quality when critical financial or collateral information is outdated); Bank Examination Quality: FRB Examinations and Inspections Do Not Fully Assess Bank Safety and Soundness, GAO AFMD-93-13, at 37-38 (Feb. 16, 1993) (stating that examiners lacked methodology to quantify identified risks); see also Thomas M.L. Metzger, FDIC Capital Directive Procedures: The Unacceptable Risk of Bias, 110 Banking L.J. 237, 254 (1993) (arguing that "an FDIC bank examiner classifies assets by custom, not rule").

257 See supra note 184 and accompanying text. Some of the noted criticisms would support a finding that agency determinations are not entitled to deference. For example, a finding that the agency relied on inadequate evidence to support its conclusions would fail the APA's substantial evidence requirement. See, e.g., First Nat'l Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674, 686-87 (5th Cir. 1983).

258 For example, perhaps courts should refrain from requiring deference to the findings of
C. Inviting a Scheme of Consistent Duties

The pitfalls of inconsistent regulation are highlighted by the disparate treatment of business decisions in formal enforcement actions versus receivership cases. For example, imposing an essentially higher standard of care in formal enforcement proceedings has the anomalous effect of making it theoretically easier for directors to avoid liability when their banks fail (subjecting them to receivership actions) than when the bank continues to operate (subjecting them to formal enforcement actions).\(^2\) This could not have been Congress's intent.\(^2\)

Inconsistent standards of care create confusion and undermine the credibility of the regulators.\(^2\) In addition, this inconsistency could frustrate banks' attempts to attract qualified individuals to serve on their boards. Although the culpability requirements discussed in Part V.B.1 compensate partially for the imbalance in the applicable standard of care, a clarification of agency enforcement policies could eliminate any remaining asymmetry.

As discussed, the agencies appear to embrace the principles underlying the business judgment rule.\(^2\) Moreover, in receivership actions brought by the FDIC or RTC, the review of directors' conduct is restrained by the business judgment rule (in state law actions) and by the section 1821(k) gross negligence standard (in actions brought under federal law).\(^2\) The agencies could apply similar restraints in formal enforcement actions brought on the basis of unsafe or unsound banking practices. To do so would set a policy that would define directors' unsafe or unsound banking practices as conduct that meets, at a minimum, the level of culpability that would apply in an action against the director in a receivership action.\(^2\) Agencies could adopt an even plainer policy by providing that cases based on unsafe or unsound banking practices will not be brought against directors unless their conduct

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\(^2\) Formal enforcement actions can be brought also against directors after banks fail. In addressing the issue of whether § 1821(k) preempts state simple negligence actions, the Tenth Circuit noted that if § 1821(k) were to preempt such actions, it would create an incentive for bank directors to allow the bank to fail because prior to failure, a simple negligence standard would apply. FDIC v. Canfield, 967 F.2d 443, 449 (10th Cir.) (en banc), cert. dismissed, 113 S. Ct. 516 (1992). It is unfathomable that directors (except the most devious ones) would allow banks to fail in order to avail themselves of a more favorable standard of liability. It is also difficult to believe that Congress intended a different standard to attach in each instance.\(^2\) See supra note 253.

\(^2\) See supra note 65 and accompanying text.

\(^2\) See supra parts I.B, I.C.

\(^2\) See supra part I.C (discussing that the applicable standard of care in most receivership cases will be gross negligence).
amounts to gross negligence or worse. Alternatively, the agencies could provide that actions alleging directors’ unsafe or unsound banking practices will focus on the process of directors’ decisionmaking and not the end results. Because all of the above proposals affect only the agencies’ cease and desist authority, the adoption of any of them would constitute a relatively modest restraint on the potential breadth of agency power and would promote a principled approach to directors’ duty of care in all actions brought by the agencies whether acting as receiver or as a regulator.

**Conclusion**

The need to attract and retain qualified individuals to serve on bank boards is widely recognized. The experience and business acumen of the board may be the difference between success or failure in today’s competitive banking industry. To attract qualified women and men, the duties imposed upon them must be well defined, clearly articulated, fair, and consistent.

If, as suggested by this Article, directors’ safety and soundness duties are akin to directors’ fiduciary duties, then safety and soundness is not an amorphous concept. Instead, safety and soundness could be said to conform to the most common form of director liability—fiduciary duty. Principles of safety and soundness, however, cannot be viewed in a vacuum. They form the basis for liability in specific formal enforcement actions. In the context of these administrative proceedings, they can serve as a basis for the imposition of a higher standard of care than that commonly applied to director conduct.

This Article concludes that although other statutory culpability requirements eliminate the imbalance in the standard of care in most formal enforcement actions, there remains some inconsistency. The agencies should implement enforcement policies that would result in a consistent standard for reviewing directors’ conduct. Absent the implementation of such policies, directors’ liability for unsafe or unsound banking practices could be used to heighten the fiduciary duties that govern director conduct. The regulators have the ability, through appropriate and well-articulated regulations, to impose duties on bank directors that exceed the duty of ordinary care. The

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265 In addition, such conduct would have to have a reasonably direct effect on the bank’s financial integrity. See supra notes 102-126.

266 See supra part V.B.1 (discussing that because of culpability requirements separate from unsafe or unsound banking practices, the standard of care in all other formal enforcement actions will be less than negligence and, perhaps, even less than gross negligence).

267 See RTC v. Gallagher, 10 F.3d 416, 422-23 (7th Cir. 1993) (noting that FIRREA’s legislative history indicates an intent to attract quality directors); see also Joint Advance Notice of Proposed Rulemaking on Standards for Safety and Soundness, 57 Fed. Reg. 31,336, 31,337 (July 15, 1992) (stating that safety and soundness standards should not be unclear because of the need to attract qualified management); Weinstein, supra note 33, at 1501 (stating that “[t]he challenge is to adhere to rules that strike the right balance—rules that sanction and deter self dealing and other fraud and also that encourage rational corporate decision making practices, while not inhibiting well qualified persons from service as directors”).

268 Increased competition from non-bank financial institutions has been cited as a factor that intensified and prolonged the collapse of the thrift industry. NATIONAL COMM’N ON FIN. INST. REFORM, RECOVERY AND ENFORCEMENT, ORIGINS AND CAUSES OF THE S&L DEBACLE: A BLUEPRINT FOR REFORM 7-8 (July 1993).
agencies' authority to impose such duties resides in their ability to define unsafe or unsound banking practices. Formal enforcement actions, however, should not be the means to achieve the same goal. Formal enforcement actions based on directors' unsafe or unsound banking practices (if such practices do not violate a law or regulation) should be used to address conduct that is in dereliction of directors' fiduciary duties (as such duties are affected by the business judgment rule) and poses a risk to the bank's financial soundness. In this way, liability for unsafe or unsound banking practices addresses both Congress's concern for the risk of bank insolvency and directors' fear of an amorphous standard.