WIB Publication

Directors Digest

Avoiding Personal Liability For Bad Loans

By Richard George, Principal, Bank Experts Group

- THE PROBLEM

  Following the Great Recession when more than five hundred FDIC-insured banks failed, the FDIC filed several hundred lawsuits or claims against individual bank directors, holding them personally responsible and accountable for the bank's failure, in part because it believed that loans were approved recklessly and negligently. In a number of cases, the FDIC has been successful in recovering some of its losses from the personal assets of the failed bank's officers and directors. The problem, therefore, is how can a director avoid such personal liability?

- CURRENT WAYS TO MITIGATE THE PROBLEM

  Traditionally, bank directors have sought ways to avoid personal liability for credit decisions taken by the board or by the bank's Loan Committee by 1) insisting that the bank maintain adequate D & O insurance, 2) not serving on the bank's Loan Committee and 3) refusing to serve on a bank board. A detailed list of recommendations to mitigate risk of personal liability can be found in the book titled FDIC Director Suits: Lessons Learned by the American Association of Bank Directors (AABD). Many of these methods can be effective, e.g. *"Establish a prudent written loan policy, an independent credit function, qualified third party loan review, and a system of checks and balances to assure effective board monitoring over the lending function"*. Others have disadvantages, e.g., D & O insurance may not be adequate. Another recommendation, delegating the approval of loans entirely to qualified bank management (except for Reg O loans and those required by state law to be approved by the board), is worthy of consideration, but it does not necessarily insulate a director from accountability. Refusing to serve on a bank board at all will deny banks generally of the valuable skills and wisdom of community leaders and capable, successful people.

I believe that the best protection for directors is to be well prepared and to do the best job he/she possibly can at all times.

- THE BEST DEFENSE – "DO YOUR JOB"!

Over the past six years, a major part of my practice has been serving as an expert witness in lawsuits brought by the FDIC alleging reckless and/or negligent behavior by the directors of failed banks. There are certain common themes that reveal themselves as the basis for these lawsuits which are discussed below.

One thing that has stood out to me in the more than 25 of these lawsuits in which I have consulted or served as the FDIC's expert witness is that when it comes to who gets sued, the FDIC has often not targeted certain directors if there was evidence that such director made a sincere effort to maintain the corporate "standard of care", that is, they kept themselves informed, acted independently and acted with a good faith belief that their decisions were in the best interests of the bank. This means they did not approve loans that were obviously flawed at the time they were presented. It appears, therefore, that "doing your job" as a bank director, even if the loan goes bad, may be the most effective defense to being held liable for your bank's demise as a result of loan losses.

It takes knowledge, attentiveness, independent thinking and courage not to "go along" with the will of the majority of a board. Performing as a capable bank director means being informed and attentive. There are numerous resources available to assist in preparing a director for his/her work and to complement the capabilities that directors normally bring with them from their own life's experience. One reference that I have seen used from time to time in banks of all sizes, is the Kansas City Fed's <u>Basics for Bank Directors.</u> This book points out that gaining a basic knowledge of banking is doable if a director is motivated to learn and, importantly, has a "questioning attitude".

- REALLY BAD LOANS ARE OBVIOUS IF YOU ARE PAYING ATTENTION AND YOU CARE ABOUT WHAT YOU ARE DOING.

  For reasons unforeseen at the time of loan approval, some loans will "go bad" and result in a loss. Other loans are bad loans from "Day One" and should never have been made. Large loan losses can impair a bank's profitability, liquidity and capital so severely as to result in the bank's failure. The loan losses that will get the attention of regulators sifting through the ashes looking for causes of the bank's failure are going to be losses from the loans that were approved recklessly and negligently. These are the ones where federal regulations, the bank's own policies and common sense have been violated, often blatantly and inexcusably. Two points rise above other reminders: 1) It is essential that an approver be fluent in his or her own bank's policies and applicable laws and that 2) directors insist the bank's policies be strictly followed by management (including strict adherence to written procedures for justifying, approving, monitoring and reporting of Exceptions to policy).

  Most of the really bad decisions I have seen deal with commercial real estate (CRE) loans; more specifically, Acquisition, Development and Construction (ADC) loans. My work typically centered on reviewing the loan approvers' decisions in light of the <u>information they had before them at the time the approval package was presented to them</u>. I then compared the decisions of the approvers to the applicable policies of the bank, regulatory guidance and sound banking industry practices. To the extent that approvers' decisions varied substantially from these standards, without viable mitigants, such actions might reasonably be judged reckless or negligent.

  I want to emphasize that most of my criticism of approvers' signing off on bad loans did not require them to look beyond the credit presentation itself. In other words, I did not expect that approvers would necessarily have carried out their own independent investigation of any portion of a presentation. There were many instances I came across when information RIGHT IN THE CREDIT MEMO gave ample reason to say "No" immediately. Most credit memos take time and care in preparing and reviewing to make sure all required underwriting topics for the type of loan are addressed. These criteria are listed in the bank's policy manual. A long credit memo does not necessarily make a stronger recommendation. A focused credit memo can adequately address every relevant issue.

  When I say "really bad" I am referring to these example situations:

  - A borrower's or guarantor's FICO score is reported right in the credit memo as (an alarmingly low) 465 yet, there is no evidence of further investigation in response to this glaring Red Flag, and the loan was approved anyway. Character is the first of the Five C's of loan approval for good reason.

- There is zero confirmed borrower equity in a large ADC loan – one of the riskiest loans a bank can make. Adequate "skin in the game" is a must.
- There may be two or even three "ways out" mentioned in the credit memo; however, a thoughtful analysis of each one reveals that none of the three is credible, so the question "How will this loan be repaid?" is unanswered (and should be discussed with the loan officer).
- There is no mention in the credit memo regarding forecasted economic or market conditions when local conditions are obviously in dire straits or headed that way. In this case, the 1st source of repayment - sales of homes or condos - as a repayment source, is unreliable. The 2nd Way Out therefore moves to first place – but is it viable?
- Guarantees are listed as one source of loan repayment, but a guarantor's financial statements as presented in the credit memo clearly shows that Net Worth is only a small fraction of the proposed loan amount or is comprised of unverified asset values. It is fair to say, based on my reviews, that "liar loans" happen in the commercial banking sector and not only in the residential sector!
- Global cash flow analysis of the borrower and guarantors is missing altogether or does not demonstrate adequate cash income or liquidity to service the bank's loan AND other liabilities.
- The bank lends outside its own defined market area or does not have the competence and experience to lend to this industry or offer this product. Inexperience with local conditions/practices or lack of product training are frequent causes of loan losses.
- No Appraisal Review was done prior to approval. Even worse, there is no appraisal at all because approval is given with delivery of the appraisal as a "condition precedent" to Closing. It is well known that an appraisal may surface surprising facts, but the money may already be "out the door".
- The credit memo recommends extending the maturity – sometimes multiple times – and possibly to increase an interest reserve with bank funds, but without any paydown on the loan or infusion of equity by the borrower. These are so-called "extend and pretend" approvals. The bank's exposure increases while the loan continues to deteriorate, making the eventual loss even larger.

Consistently failing to recognize the above red flags and consequently making bad loan decisions can result in a bank's failure. Based on my recent experience, I believe that bank failures could be reduced and directors could better protect themselves by 1) being prepared, 2) paying attention, 3) exercising good judgment and, above all, 4) ensuring their bank plays by the rules.

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