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Director Liability: Recent Developments

Norwood Beveridge

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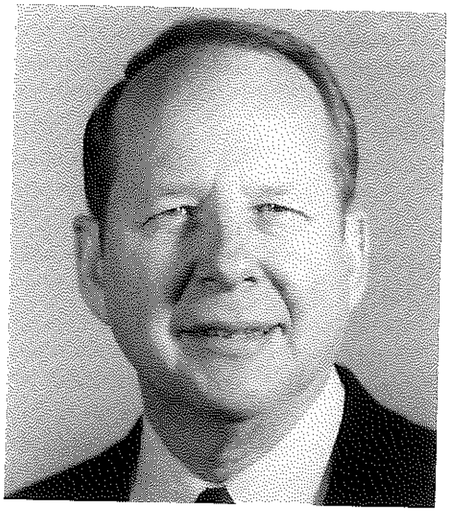
By Norwood P. Beveridge, Jr.



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I. Introduction

Three recent cases have presented points of interest in the field of liability of corporate directors. These are treated herein in no particular order of importance. It may be said at the outset that these cases do not point uniformly towards a stricter or looser or even more coherent body of law, in the opinion of the writer.

A. *Sandberg v. Virginia Bankshares, Inc.,*[1]

This case has recently been settled after a long and interesting journey through the federal and Virginia state courts. The facts were that First American Bankshares, Inc. (First American)[2] had caused a freezeout merger of First American Bank of Virginia (the "Virginia Bank") with Virginia Bankshares, Inc., a wholly-owned First American subsidiary which at that time owned 85% of the outstanding shares of the Virginia Bank.[3] The 15% minority shareholders of the Virginia Bank were paid in cash $42. per share, a figure arrived at by Keefe, Bruyette and Woods, investment advisors retained by First American to render an opinion as to a "fair price" for the minority shares.[4]

Attempts by plaintiff minority shareholder Paul H. Weinstein to obtain relief against the merger in the Virginia state courts were unproductive, but plaintiff Doris I. Sandberg had better luck in the federal courts, and plaintiff Weinstein ultimately joined her there.[5] A jury determined that First American and the directors of the Virginia Bank had violated the federal proxy rules in soliciting proxies for the merger from the minority shareholders and that the Virginia Bank directors had violated their fiduciary duties under state law.[6] Based on the jury finding that $60. per share was the fair value of the minority stock, the court entered judgment for plaintiff Sandberg for $43,956 ($18. per share for 2,442 shares), having denied her motion for class certification.[7]

Plaintiff Weinstein and other minority shareholders who joined with him were able to obtain summary judgment on the basis of Sandberg's jury verdict, and judgment of $3,292,236 was entered on their behalf for violation of the federal securities laws.[8] On the state law violation of fiduciary duty, however, judgment was entered for only $2,346,553.34 because of a cap on liability for the twenty defendant directors imposed by Virginia statute at the greater of $100,000 per director or the previous twelve months' compensation of a director.[9] On appeal to the Fourth Circuit, the judgments were affirmed, except the district court was ordered to certify a class of all minority shareholders in the *Sandberg* case, excluding only the *Weinstein* plaintiffs, and to reconsider the denial of counsel fees.[10] The Court of Appeals held that, among other alleged misrepresentations, statements in the proxy statement that the Virginia Bank's directors recommended the $42. offer as a "high value" and "fair" justified the jury's verdict.[11]

The United State Supreme Court granted certiorari limited to the federal question[12] and reversed, holding that since the merger did not require the approval of the minority shareholders, they could not prove that the false and misleading proxy statement had

1. 891 F.2d 1112 (4th Cir. 1989), *rev'd,* 111 S. Ct. 2749 (U.S. 1991), *on remand,* 979 F.2d 332 (1992), *motion to vacate granted,* Nos. 91-1873, 91-1874 (4th Cir. April 7, 1993). The case was settled on March 12, 1993 with the approval of the district court. As part of the settlement, plaintiffs' counsel received fees and expenses of $2.9 million. Following settlement, a motion to vacate the Court of Appeals decision on remand was filed on March 29, 1993 and granted a few days later.
2. According to later allegations, First American at this time was secretly controlled by the Bank of Credit and Commerce International, which was closed in 1991 by regulators amid multiple charges of violations of law. *See generally* JAMES RING ADAMS AND DOUGLAS FRANTZ, A FULL SERVICE BANK: HOW BCCI STOLE BILLIONS AROUND THE WORLD, (1992). First American President Robert A. Altman and his associate Clark Clifford are now facing state and federal criminal charges in New York and Washington, D.C., *see* Peter Truell, *Airing a Scandal,* Wall St.J., March 30, 1993, at A1.
3. 891 F.2d at 1116-1118.
4. *Id.*
5. *Id.*
6. 979 F.2d at 340.
7. *Id.*
8. *Id.*
9. 979 F.2d at 340-342.
10. 891 F.2d at 1126-27.
11. 891 F.2d at 1121.
12. 495 U.S. 903 (1990).

caused them any damage.[13] The Court of Appeals remanded the case to the District Court to assess the effect of the Supreme Court decision, and the District Court then entered a class certification which included all plaintiffs and a judgment which reflected the cap imposed by the Virginia statute.[14] In a surprising decision, the Court of Appeals then reversed as to the *Sandberg* plaintiffs, holding first that they had not waived their right to challenge the applicability of the state liability cap (although the *Weinstein* plaintiffs had) and then that as a matter of law the jury verdict established that the cap was inapplicable.[15] The result was that the District Court was ordered to enter an uncapped judgment of over $12.2 million in favor of the *Sandberg* plaintiffs against the Virginia Bank directors and to grant a new trial against First American on the state causes of action.[16] However, following the Court of Appeals decision, the case was settled, and a motion to vacate the opinion was granted.

The holding that the statutory cap was inapplicable required the Court of Appeals to find that the jury necessarily held the directors guilty of a knowing violation of the federal securities laws.[17] This in turn required a finding that an erroneous instruction had been given to the jury since neither the state nor the federal claim in *Sandberg* required the plaintiff to prove any knowing violation of law.[18] The applicability of the cap was not before the jury in *Sandberg* since the District Court had refused to certify a class of shareholders, and her individual damages were far less than the statutory cap.[19] However, it was at issue for the *Weinstein* plaintiffs, and they did not even argue that the jury necessarily found the directors guilty of conduct that would make the cap inapplicable; this resulted in the Court of Appeals holding that they had waived the argument.[20] The result is that the directors have been deprived of their right to a trial on the issue of a knowing violation of law, and the judgment against them has been increased by $10 million.

B. *Washington Bancorporation v. Said*[21]

This action by the Federal Deposit Insurance Corporation as receiver for the National Bank of Washington (the "Bank") against its directors and an officer of the Bank raises again the question of the standard of care for bank directors recently discussed in this Journal.[22] In a lengthy decision, the court dimissed all claims against nine outside directors. Out of 42 counts, 31 were dismissed for failure to state a cause of action, and an additional seven were dismissed on motion for summary judgment.[23] Four counts were left against two directors.[24]

With respect to the standard of care, the court held that the gross negligence provisions for director liability of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 did not preempt a cause of action for ordinary negligence if one existed under applicable state law.[25] After this correct beginning, however, the court abandoned any straightforward analysis. First, the court held that it would not have to decide whether District of Columbia or federal common law governed since it found both standards to be the same.[26] Then the court held that the standard of gross negligence applied to the challenged transactions since they were entered into in the ordinary course of the bank's business, while indicating that a standard of ordinary negligence would apply if the transactions were out of the ordinary.[27] This unprecedented approach loads the wrong end of the standard, which has historically been that of an ordinarily prudent person under the circumstances.[28] If the transaction is out of the ordinary course of business, this is simply one of the circumstances to be considered in determining whether the director exercised due care. It does not change the standard of care. With respect to the standard itself, the fact is that in the director liability cases there is no difference between the gross negligence and ordinary negligence standards.[29] The courts that have used the gross negligence standard in this century have used it as a shorthand for the business judgment rule, which only imposes liability for gross ignorance or gross error of judgment.[30]

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13. 111 S. Ct. 2749 (1991). *See* Rosalie Wacker O'Brien, *Business and Corporate Law*, 25 U. Rich. L. Rev. 627, 628-636 (1991).

14. 979 F.2d at 339.

15. 979 F.2d at 343.

16. 979 F.2d at 341, 356.

17. 979 F.2d at 343. The relevant Virginia statute provides that:

    B. The liability of an officer or director shall not be limited as provided in this section if the officer or director engaged in willful misconduct or a knowing violation of the criminal law or of any federal or state securities law, including, without limitation, any claim of unlawful insider trading or manipulation of the market for any security.

    Va. Code Ann. § 13.1-692.1.B (Michie. 1989), cited 979 F.2d at 342.

18. The prevailing rule in the federal courts is that negligence will suffice to prove a violation of the proxy rules. *See* Wilson v. Great American Industries, Inc., 855 F.2d 987, 995 (2d Cir. 1988); Shidler v. All American Life & Financial Corp., 775 F.2d 917, 926-27 (8th Cir. 1985); Gould v. American-Hawaiian S. S. Co., 535 F.2d 761, 777-78 (3d Cir. 1976); United Paperworkers Intern. Union v. International Paper Co., 801 F. Supp. 1134, 1139 (S.D. N.Y. 1992), *mod. other grounds*, 985 F.2d 1190 (2d Cir. 1993); *cf.* Adams v. Standard Knitting Mills, Inc., 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980) (scienter required for liability of outside auditors). The United States Supreme Court has reserved the question, *Sandberg*, 111 S. Ct. at 2757, n. 5, and so has the Court of Appeals for the Fourth Circuit, *Sandberg*, 979 F.2d at 345, n. 11. The state claim in *Sandberg* merely required the plaintiff to prove that the directors did not exercise their good faith business judgment of the best interests of the corporation, Va. Code Ann. § 13.1-690.A. (Michie. 1989); Izadpanah v. Boeing Joint Venture, 412 S.E.2d 708 (Va. 1992).

19. 979 F.2d at 343.

20. 979 F.2d at 342-43.

21. 812 F. Supp. 1256 (D. D.C. 1993).

22. *See* Norwood P. Beveridge, Jr., *Duty of Care of Directors of Insured Depository Institutions Under FIRREA: Understanding the Gross Negligence Statutory Provisions*, 47 Consumer Fin. L.Q. 67 (1993), in which the author concludes that the "gross negligence" provisions for director liability in FIRREA were correctly held not to preempt liability under state law for ordinary negligence in FDIC v. Canfield, 967 F.2d 443 (10th Cir. (en banc), *cert. dismissed*, 113 S. Ct. 516 (U.S. 1992).

23. 812 F. Supp. at 1279-80.

24. *Id.*

25. 812 F. Supp. at 1264-65.

26. 812 F. Supp. at 1265.

27. 812 F. Supp. at 1265-66.

28. *See generally*, Norwood P. Beveridge, Jr., *The Corporate Director's Duty of Care: Riddles Wisely Expounded*, 24 Suffolk U.L. Rev. 923 (1990); Martin Lowry, Esq., *Ruling May Help Free Directors From Regulatory Reign of Terror*, Am. Banker, May 28, 1993 at 4.

29. *See* Beveridge, *supra* note 28.

30. *Id.* The guidelines for directors and officers issued November 16. 1992 by the Office of Thrift Supervision do not shed any light on this important subject, *see OTS Guidelines On Conduct Emphasize Duties of Loyalty, Care*, BNA's Corp. Couns. Wkly., Nov. 25, 1992, at 3. In fact the guidelines are too general to be of much help, and when they make statements like the one that the duty of care means "making business decisions on the basis of fully informed and meaningful deliberation," they are counterproductive. No director has ever made a fully informed decision. All decisions are made in a situation of more or less uncertainty; that is the reason for the business judgment rule. The question of how much information to gather before making a decision is a business decision like any other. The gathering of information carries a cost in time and money, and the price for being fully informed would mean that no decision could be made in a timely fashion.

Other provisions of section 131, however, are more troublesome and will require the passage of time in order to determine if they are beneficial or not. For example, will those provisions of the Act which require the agencies to implement rules on credit underwriting standards exacerbate the "credit crunch"? Note also that the standard for well capitalized institutions will require an institution to hold 25% more total risk-based capital, 50% more Tier 1 capital, and 66% more leverage capital than an adequately capitalized institution. Because several provisions of the Act impose new and additional constraints on institutions which are not well capitalized, several commentators have expressed concern that the well capitalized category is or will become the de facto minimum capital category, which in turn could restrict credit availability as institutions reduce the rate of growth or shrink assets in order to increase their capital.

Will the holding company performance guarantee scare off new capital from the industry? Will the early intervention requirements for undercapitalized institutions have an adverse impact on the ability of management to weather cyclical downturns in the economy, especially when access to the discount window has been hampered? The automatic intervention process may also discourage private investors from injecting capital into marginal institutions. Only time will tell.

Perhaps what is most troublesome about section 131, and the other provisions of the FDICIA, is that Congress has attempted to place (and many ways succeeded in placing) the financial institutions regulatory process on auto-pilot. The Act as a whole appears to be premised on the belief that Congress must dictate the supervisory process because the agencies are incapable of doing it themselves. Although the agencies must shoulder some of the blame for the thrift and bank crises, there is undoubtedly plenty of blame left over to be distributed. Moreover, and although it can and has been abused, regulatory and supervisory *discretion* is useful. Although section 131 makes available to the agencies both mandatory and discretionary enforcement tools, in other ways the Act seems only to pay homage to the concept to discretion. For example, critically undercapitalized institutions must be placed into conservatorship or receivership unless the head of the appropriate agency sets forth in writing why a temporary reprieve is in order. The inspector general will render reports to Conress reviewing the agencies' actions on all failures where there is a "material loss." How willing will the Federal Reserve be to serve as a lender of last resort when it may incur monetary liability for doing so? In fact, after the proposed section 131 rules were issued for comment, several commentators expressed concern that section 131 unduly restricted regulatory flexibility and discretion. Commentators argued that a narrow focus on capital levels to the exclusion of other indications of financial strength could result in unnecessary and counterproductive actions being taken against financially sound institutions. The agencies sympathized with these commentators and stated that they attempted to retain flexibility "to the extent possible under the statute."

It is hoped that despite these intimidating provisions, the agencies will not shirk from employing the exceptions to section 131 when they are warranted. Courts have upheld the use of regulatory discretion against shareholders, directors, etc. It will indeed be unfortunate if in the course of anointing Capital as King, Congress has relegated discretion to oblivion.

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C. *FDIC v. American Cas. Co. of Reading, Pa.*[31]

The much-litigated question of the validity of a regulatory exclusion in a directors' and officers' liability policy was recently decided in the Colorado Supreme Court. Sitting *en banc* and dividing four justices to three, the court held that a "regulatory exclusion" which relieved the insurer from paying for any loss due to claims against the bank's directors or officers by the FDIC or other national or state regulatory agencies was violative of state public policy.[32] Since the FDIC had obtained a $3.2 million default judgment against two of the bank directors, it will be able to collect that judgment up to the $1 million policy limit as a result of this decision, which reversed the Colorado Court of Appeals on the point.

No intellectually responsible argument can be made in defense of this decision, which is the first state court decision to uphold the FDIC on this point[33] and which flies in the face of overwhelming federal authority on the question.[34] Since Congress has not chosen to require D&O coverage for bank officers and directors, the bank did not have to provide any insurance coverage at all. The fact that it provided a policy with a regulatory exclusion then could hardly be said to violate any articulated public policy, state or federal. One might as well say that the policy limit of $1 million violates public policy since the loss exceeded that amount. Justice Quinn, the author of the majority opinion, left the Supreme Court on January 11, 1993, the day of the denial of rehearing in the case. The state banking laws have been amended, effective May 4, 1993, to overturn the effect of the decision.[35]

31. 843 P.2d 1285 (Colo. 1992), *on remand*, Nos. 89CA2168, 90CA0264, 1993 WL 169827 (Colo. App. May 20, 1993) (insured vs. insured exclusion also violates state public policy).

32. The court stated in relevant part:

> Although we conclude that the regulatory exclusion is unambiguously written so as to exclude coverage for common law claims asserted by the FDIC against the former directors of the insolvent bank, we hold that judicial enforcement of the

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32. *(Continued from previous column)*

> regulatory exclusion contravenes the important public policy underlying the Colorado Banking Code of 1957 [citation omitted] of vesting the FDIC, in its role as liquidator of an insolvent state-chartered bank, with the authority and responsibility for protecting the legitimate interests of the bank's depositors, creditors, and stockholders by marshalling the bank's assets and equitably compensating them for their losses resulting from the negligence and breach of fiduciary duty on the part of the bank's former directors.

843 P.2d at 1287.

33. *See contra* Finci v. American Casualty Co., 593 A.2d 1069 (Md. 1991) (no violation of Maryland public policy in regulatory exclusion).

34. *See* FDIC v. American Cas. Co., No. 92-1447, 1993 WL 143755

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34. *(Continued from previous column)*

(4th Cir. May 6, 1993); Fidelity & Deposit Co. of Maryland v. Conner, 973 F.2d 1236 (5th Cir. 1992); FDIC v. Aetna Cas. and Sur. Co., 903 F.2d 1073 (6th Cir. 1990); St. Paul Fire and Marine Ins. Co. v. FDIC, 968 F.2d 695 (8th Cir. 1992); FDIC v. American Cas. Co., 975 F.2d 677 (10th Cir. 1992).

35. Colo. House Bill 93-1261, 59th Gen. Ass., 1st Reg. Sess., 1993 CO H.B. 1261 (SN), signed by the Governor April 30, 1993.