No. 14-2078

IN THE

United States Court of Appeals

FOR THE FOURTH CIRCUIT

FEDERAL DEPOSIT INSURANCE CORPORATION,
AS RECEIVER FOR COOPERATIVE BANK,

Plaintiff-Appellant,

v.

RICHARD ALLEN RIPPY; JAMES D. HUNDLEY; FRANCES PETER FENSEL, JR.; HORACE THOMPSON KING, III; FREDRICK WILLETTS, III; DICKSON B. BRIDGER; PAUL G. BURTON; OTTIS RICHARD WRIGHT, JR.; OTTO C. BUDDY BURRELL, JR.,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF NORTH CAROLINA
IN CASE NO. 7:11-CV-165-BO

BRIEF OF *AMICI CURIAE* AMERICAN BANKERS ASSOCIATION AND STATE BANKING ASSOCIATIONS IN SUPPORT OF DEFENDANTS-APPELLEES

[Additional amici listed on inside cover]

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STATEMENT OF *AMICI CURIAE*[1]

The American Bankers Association ("ABA"), headquartered in Washington, D.C., is the principal national trade association of the financial services industry. The ABA's members—located in all fifty states, the District of Columbia, and Puerto Rico—include financial institutions of all sizes and hold a majority of the domestic assets of the U.S. banking industry.

This case implicates important interests of the ABA's members. Continued adherence to the business judgment rule and its implication that bank directors and officers are not subject to ordinary negligence claims regarding their business decisions is critical to ABA member banks and their directors and officers. Acceptance of Plaintiff-Appellant's contrary position would seriously undermine the important economic and social interests underlying the business judgment rule, impair the wide distribution of low-cost credit, and flout controlling North Carolina law.

Also appearing as *amici* are 54 bankers associations from all 50 states and Puerto Rico. These associations represent the interests of their members (which include state and federally chartered banks, as well as savings and loan associations) at the state and local level.

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[1] This brief was not authored by any of the parties' counsel, in whole or in part. No party or party's counsel contributed money that was intended to fund preparing or submitting the brief; no person other than the *amici*, their members, and their counsel contributed money that was intended to fund preparing or submitting the brief. All parties have consented to the filing of this brief.

INTRODUCTION

This appeal concerns the business judgment rule—one of the most important, well-established, and socially and economically beneficial common-law rules of corporate governance. Formally, the rule protects disinterested corporate officers and directors from personal liability for good-faith business judgments made through a rational process. Functionally, the rule fosters entrepreneurship and growth that benefit not just the corporation and its shareholders, but also society at large.

Plaintiff-Appellant the Federal Deposit Insurance Corporation ("FDIC") seeks to effectively eliminate the protection the rule provides under North Carolina law, contending that directors and officers may be held personally liable for ordinary negligence in their business judgments. *See* FDIC Br. 33-42. That would negate decades of established case law, undermine the sound policy rationale supporting the rule, and diminish the rule's economic and social benefits.

As deposit insurer and receiver, FDIC bears losses when banks fail but does not share in gains when banks succeed. Predictably, therefore, FDIC seeks to shift to others some of the losses bank receivers could otherwise bear. However, its proposed standard of liability would discourage appropriate and desirable risk-taking that leads to improved, more efficiently provided, and more widely distributed banking products—the very type of decision-making the business judgment rule was created to protect.

This Court should reject FDIC's attempt to rewrite North Carolina's common law to advance the agency's interests at the expense of the societal benefits of a robust business judgment rule.

ARGUMENT

I. THE STANDARD FDIC PROPOSES WOULD INHIBIT USEFUL AND EFFICIENT BUSINESS ACTIVITY.

FDIC seeks to undermine North Carolina's business judgment rule to permit plaintiffs representing a corporation, such as FDIC as receiver, to assert claims for ordinary negligence—rather than, in accordance with established precedent, only claims for gross negligence—against directors and officers. *See* FDIC Br. at 33-42. For its position, FDIC erroneously relies upon North Carolina's statutory standard of care, which requires that directors and officers act "with the care an ordinarily prudent person in a like position would exercise under similar circumstances," to the exclusion of the common-law business judgment rule. *See id*. at 36 (citing N.C. Gen Stat. §§ 55-8-30, 55-8-42). According to FDIC, a business judgment rule that bars claims for ordinary negligence would conflict with the statutory standard and therefore cannot be the law of North Carolina. *Id.* at 36-41. That argument is at odds with prevailing case law and would eviscerate legal protection critical to advancing important social and economic goals.

A. The Business Judgment Rule Furthers Important and Widely Recognized Social and Economic Benefits.

North Carolina, like many jurisdictions, treats the business judgment rule as a cornerstone corporate legal principle embodying sound and desirable policy. As the North Carolina Supreme Court has recognized, chief among the "[n]umerous salutary policy reasons for the rule" is that it benefits society by freeing directors and officers to pursue "risk-taking, innovation and venturesome business activity." *Alford v. Shaw*, 349 S.E.2d 41, 47 n.5 (N.C. 1986) *on reh'g*, 358 S.E.2d 323 (1987);[2] *see also Currie v. United States*, 644 F. Supp. 1074, 1083 (M.D.N.C. 1986) ("a rule which penalizes the choice of seemingly riskier alternatives ... may not be in the interest of the parties or society") (citation omitted), *aff'd*, 836 F.2d 209 (4th Cir. 1987). It is a "desirable" public policy goal "to encourage directors and officers to enter new markets, develop new products, innovate, and take other business risks." ALI, *Principles of Corporate Governance*, § 4.01(c) cmt. c (2012).

A robust business judgment rule aligns directors' and officers' incentives with those of shareholders and society. The rule is necessary because "corporate directors and officers invest other people's money." William T. Allen, Reiner Kraakman, and Guhan Subramanian, *Commentaries and Cases on the Law of Business Organizations* 243 (2d. ed. 2007). As a result, "[t]hey bear the full costs of any personal liability, but they receive only a small fraction of the gains from a risky decision." *Id.* "[U]nder a negligence standard," this misalignment "would

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[2] Although *Alford's* holding was reversed upon rehearing, the reversal involved a separate issue; the Court did not disclaim its description of the importance and purpose of the business judgment rule.

predictably discourage officers and directors from undertaking valuable but risky projects." *Id.*

A widely cited decision of the Delaware Court of Chancery, to which North Carolina courts traditionally turn as an authoritative source of corporate law, includes a similar explanation:

> Shareholders don't want (or shouldn't rationally want) directors to be risk averse. Shareholders' investment interests … will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital.
>
> But directors will tend to deviate from this rational acceptance of corporate risk *if* in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to *ex post facto* claims of derivative liability for any resulting corporate loss. …
>
> [I]t is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss.

Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996); *see also Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982) ("because potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions").

The business judgment rule thus "recognizes that directors often make important decisions under fluid and uncertain circumstances and that a court must be loathe to review such judgments on the basis of *ex post* judicial hindsight." *Ehrenhaus v. Baker*, No. 08-CVS-22632, 2008 WL 5124899, at *12 (N.C. Bus. Ct.

Dec. 5, 2008). Indeed, courts often "are not able to appraise accurately the issues of value and business purpose subsumed within a board's decision." David E. Brown, Jr. et. al., *Strategic Alliances: Why, How, and What to Watch for*, 3 N.C. Banking Inst. 57, 93 (1999). As Judge Posner has explained, "hindsight bias" and the risk of failure may combine to "make corporate managers *too* cautious, since they may be blamed for taking sensible risks should the risks turn out badly (which, in the nature of risk, they may)." Richard A. Posner, *Economic Analysis of Law* 547 (9th ed. 2014) (emphasis in original) ("Posner").

B. An Ordinary Negligence Standard Would Discourage Qualified Potential Directors and Officers from Serving.

The availability of qualified individuals willing to serve as corporate directors and officers is paramount to healthy industry, including banking. *See, e.g.*, *State v. Custard*, No. 06-CVS-4622, 2010 WL 1035809, at *15 (N.C. Bus. Ct. Mar. 19, 2010) ("*Custard II*") ("The corporate structure requires competent directors willing to serve."). Indeed, FDIC has acknowledged that banks must "be able to attract and to retain experienced and conscientious directors and officers" to steer their institutions on a "sound and prudent" path. FDIC, *Statement Concerning the Responsibilities of Bank Directors and Officers* (1992).[3] And FDIC recognizes that this is critical during times of economic stress, such as the 2008 economic crisis: "When an institution becomes troubled, it is especially important that it have the benefit of the advice and direction of people whose

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[3] *Available at* https://www.fdic.gov/regulations/laws/rules/5000-3300.html.

experience and talents enable them to exercise sound and prudent judgment." *Id.* Courts have recognized this guiding principle: "If corporate value is to be enhanced, the courts must not discourage qualified and capable people from serving as directors and taking risks." *First Union Corp v. SunTrust Banks, Inc.*, No. 01-CVS-10075, 2001 WL 1885686, at *4 (N.C. Bus. Ct. Aug. 10, 2001).

The approach FDIC advocates here, however, would have just this discouraging effect: it would deter qualified candidates from serving. "[T]o attract competent directors ... we [must] defer to their business judgment." *Custard II*, 2010 WL 1035809 at *15. Indeed, "[n]o rational business person would sit on [a] board" if an ordinary negligence standard applied. *State v. Custard*, No. 06 CVS 4622, 2007 WL 2570241, at *11 (N.C. Bus. Ct. Aug. 8, 2007) ("*Custard I*"). The business judgment rule, and its corresponding heightened standard of liability, is thus "beneficial to corporate shareholders as a class" because "it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors." *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996). Without it, "persons of reason, intellect, and integrity would not serve." S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93, 97 (1979). Asking them to take on liability for good-faith business decisions under an ordinary negligence standard therefore could, as one court put it, "effectively destroy the corporate system in this county, for no individuals would serve as officers and directors." *Washington Bancorporation v. Said*, 812 F. Supp. 1256, 1268 (D.D.C. 1993).

Empirical evidence confirms these courts' conclusions. For example, 40% of respondents to a recent survey by the ABA of its member banks reported that at least one qualified candidate had declined to seek or assume a director or officer position due to concerns about personal liability, and 20% reported that such concerns had caused (at least in part) a director or officer at their institution to *cease serving*. Ex. A, ABA, *Member Survey Concerning Scope of Protection Under the Business Judgment Rule* (Jan. 2015), at 15-16. Among individual director or officer respondents, nearly all (97%) reported that they were somewhat or very concerned with potential personal liability for their business decisions, and a large majority (87%) reported that a reduction in the legal protection against personal liability would affect their willingness to serve in the future. *Id.* at 8, 10.

An earlier survey by the American Association of Bank Directors ("AABD") yielded similar results: 24.5% of the responding banks reported that at least one individual had resigned from or declined to accept a director or officer role in the past five years due to fear of personal liability. AABD, *Measuring Bank Director Fear of Personal Liability* (Apr. 2014), *available at* http://aabd.org/aabd-survey-results-measuring-bank-director-fear-personal-liability-good-news/. And almost half of banks reported that at least one qualified individual had declined to join their board in the first place for the same reason. *Id.*

Concern about personal liability in this context is understandable not only because of the monetary stakes involved, but also because even well-founded decisions may appear lacking when examined with the benefit of hindsight. Indeed, "after-the-fact litigation is a most imperfect device to evaluate corporate business decisions." *Joy*, 692 F.2d at 886; *Alford*, 349 S.E.2d at 48 (courts "are ill equipped . . to evaluate what are and must be essentially business judgments"). Courts generally "review a single transaction at a time," making it "very difficult to tell whether the litigated misfortune is due to [b]ad luck or bad decision making." Leo Herzel & Leo Katz, Smith v. Van Gorkom*: The Business of Judging Business Judgment*, 41 Bus. Law 1187, 1189 (1986). While "the court has to judge a director by a single swing of the bat," "the market can [instead] look at the batting averages." *Id.* The evaluation of a "director's business acumen and [the] disciplining [of] his or her lapses" is thus "accomplished much more efficiently by the market for directors" than by judicial review. *Id.*

C. An Ordinary Negligence Standard Would Spur Unwarranted Litigation and Make Credit More Costly.

The business judgment rule not only preserves socially and economically desirable incentives, but it also protects against the unwarranted drain on judicial and societal resources that FDIC's proposed standard would prompt.

Ordinary negligence claims are relatively easy to plead but difficult to dismiss, even following discovery. *See, e.g.*, *Nicholson v. Am. Safety Utility Corp.*, 488 S.E.2d 240, 244 (N.C. 1997) (issues of ordinary negligence are "ordinarily questions for the jury and are rarely appropriate for summary judgment"). Such claims—even if meritless—are thus likely to proceed past the pleadings stage to discovery and even to trial. *See id.* By recent estimates, the cost associated with defending a single claim for director or officer misconduct is nearly $700,000 for a private company,[4] and likely more for a larger, public company—in addition to the substantial expenditure of employee time. Given the exceedingly high cost of discovery—to say nothing of trials—banks may be under extreme pressure to settle even baseless claims. Even if ultimately not successful on the merits, these suits would consume resources with no offsetting benefit. *See Alford*, 349 S.E.2d at 51 ("a favorable business climate" is "fostered in part by ... providing a measure of protection against ... nuisance suits").

Ultimately, such suits would make credit more expensive, with adverse ripple effects throughout the economy. For example, the imposition of a higher standard of care for directors and officers would increase the costs associated with banks' credit evaluation and loan approval processes. More searching judicial review of business decisions "is not without its costs." *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987). Whereas "protecting directors' reasonable risks is considered positive for the economy overall," *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 882 (Minn. 2003), as it allows banks (and other businesses) to "adapt to changing markets" and "capitalize on emerging trends," *id.*, removing such protection "makes directors overcautious ... and leads [them] to adopt ponderous, court-like procedures," *Dynamics Corp.*, 794 F.2d at 256. Indeed, 75% of the respondents in

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4 Chubb Group, *Worth the Risk? Highlights from the Chubb 2013 Private Company Risk Survey* 9 (2013), *available at* http://www.chubb.com/businesses/csi/chubb12192.pdf.

the ABA's recent survey reported that increased liability for directors and officers would likely increase the costs of extending credit. Ex. A at 13.

As a corollary effect, adoption of FDIC's position would also increase banks' insurance costs. In the ABA's survey, the legal environment was identified most consistently as the factor influencing changes to the terms of banks' D&O liability coverage, including premiums, deductibles, and policy limits and scope. *Id*. at 19. These results comport with historical trends in the market for D&O coverage, where premiums have risen concurrently with legal changes that potentially expand liability. *See*, *e.g.*, Diane L. Saltoun, *Fortifying the Directorial Stronghold: Delaware Limits Director Liability*, 29 B.C. L. Rev. 481, 498-99 (1988). In particular, when legal uncertainty exists as to the application of a liability standard, "[t]he upshot [is] increased uncertainty in D&O risk assessment." Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 Del. J. Corp. L. 1, 25 (1989). This can cause rates to rise, and if drastic enough, prompt insurers to drop out of the market. *See* Saltoun, *supra*, at 499 n.200.

D. An Ordinary Negligence Standard Would Constrain Credit Distribution.

Beyond encumbering the market for qualified directors, breeding unwarranted litigation, and increasing societal costs, adopting what "appear[s] to be [an] ordinary negligence [standard]" for director liability also has a "perceived detrimental impact on director risk taking." *First Union*, 2001 WL 18856686, at *11. Such a rule, "which penalizes the choice of seemingly riskier alternatives," is not "in the interest of shareholders generally" or society more broadly. *Joy*, 692 F.2d at 886. Instead, encouraging appropriate risk-taking in the banking industry is vital for credit access and economic health.[5] It is also how financial institutions make the returns that enable them to continue operating and serving their communities' needs. *See In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 126 (Del. Ch. 2009).

Uncertainty about potential personal liability discourages "novel transactions," where "application of [an appropriate liability] standard is in flux." Romano, *supra*, at 24. In the credit context, such uncertainty will typically lead a bank to confine its lending to existing customers of proven reliability and other customers of high-worth and well-established credit histories. In fact, 76% of respondents to the ABA's survey reported that a decrease in the protections from personal liability for directors and officers will likely result in decreased volume of lending to underserved market segments, and 80% reported the same with respect to new borrowers. Ex. A at 13. Such a result is plainly contrary to sound public policy and banking objectives—"the availability of credit to consumers and businesses is critical to the efficient functioning of our economy."[6]

[5] The extent to which banks can permissibly incur risk is strictly limited by the extensive and detailed regulation and supervision of the banking industry by both federal and state regulators.

[6] Fed. Reserve Bd. of Governors, Press Release (Feb. 17, 2011), *available at* http://www.federalreserve.gov/newsevents/press/other/20110217a.htm.

II. FDIC'S PROPOSED ORDINARY NEGLIGENCE STANDARD CONTRAVENES GOVERNING LAW.

Not only is FDIC's position at odds with the important policies supporting the business judgment rule, it also is untenable as a matter of law. FDIC disregards the authorities that the North Carolina Supreme Court would use to define the state's business judgment rule, relying instead on authorities from other states with no bearing on North Carolina's rule. FDIC advocates for a standard inconsistent with the applicable case law and other persuasive authorities, all of which confirm that the business judgment rule bars ordinary negligence claims.

A. FDIC Relies Upon Authorities That North Carolina's Supreme Court Would Not Apply.

When this Court is charged with interpreting state law and has "no controlling precedent from the Supreme Court of North Carolina on [an] issue, [it is] confronted with the task of predicting how that court would rule." *AGI Assocs., LLC v. City of Hickory, N.C.*, 773 F.3d 576, 579 (4th Cir. 2014). "In such circumstances, the state's intermediate appellate court decisions constitute the next best indicia of what state law is." *Id.* (citation omitted). In addition to those decisions, it is appropriate to consider other authorities that the state high court would deem relevant, such as "canons of construction, restatements of the law, treatises, recent pronouncements of general rules or policies by the state's highest court, well considered dicta, and the state's trial court decisions." *Wells v. Liddy*, 186 F. 3d 505, 528 (4th Cir. 1999).

Particularly instructive are the decisions of the North Carolina Business Court, which is viewed as "the current gold standard in established non-Delaware business courts." Anne Tucker Nees, *Making A Case for Business Courts: A Survey of and Proposed Framework to Evaluate Business Courts*, 24 Ga. St. U. L. Rev. 477, 479, 482 (2007). The judges of the Business Court are nationally recognized for their expertise in matters of corporate law, alongside their brethren in Delaware and a handful of other states, and they experience very low reversal rates. *See id.* at 482, 522.

FDIC, however, urges this Court to refer to out-of-state authorities upon which the North Carolina Supreme Court would not rely. *See* FDIC Br. 39. That suggestion is misguided.

B. Applicable Authority Contravenes FDIC's Position.

The judicial precedent applicable in this case amply confirms that allegations of ordinary negligence cannot overcome the North Carolina business judgment rule's presumption of propriety.

1. North Carolina Courts Have Long Recognized the Value of the Business Judgment Rule.

Under North Carolina law, the business judgment rule has long served as a cornerstone legal principle, providing "the yardstick against which the duties and decisions of corporate officers and directors are measured." *Alford*, 349 S.E.2d at 47. As explained in *Alford*, the rule's provenance may be traced to nineteenth-century United States Supreme Court jurisprudence, *id.* (citing *Hawes v. Oakland*, 104 U.S. 450, 458 (1882)), and its incorporation into state common law dates back at least as far as 1919, *id.* (citing *Besselieu v. Brown*, 97 S.E. 743 (N.C. 1919)).

During this long history, North Carolina courts have repeatedly recognized that the business judgment rule "achieve[s] a balance between the need to hold management accountable for legitimate wrongs committed against the corporation and the need to ensure that management is accorded necessary decision-making discretion and concomitant protection from liability." *Id.* at 47-48 & n.5. This protection "from unfair retrospective reviews of [management's] mistakes" ensures "that directors are managers, not insurers, of the corporation's success." *Id.* at 47 n.5 (citations omitted).

North Carolina's legislature acknowledged these principles in drafting the Business Corporation Act. The legislature could have displaced the business judgment rule statutorily. But "[a]s with other portions of the Business Corporation Act, this section [regarding the standard of conduct for corporate officers and directors] is not meant to abrogate the common law." *State ex rel. Long v. ILA Corp.*, 513 S.E.2d 812, 821 (N.C. Ct. App. 1999) (citing the statute's official commentary that it "embodies long traditions of the common law").

2. North Carolina Case Law Confirms that the Rule Requires More Than Simple Negligence for Directors and Officers to Become Liable.

a. The Rule Insulates Directors and Officers from Negligence-Based Claims Based on Decisions Made in Good Faith, Without Conflict of Interest, and Using an Informed and Rational Process.

The sources of authority that the North Carolina Supreme Court would rely upon to interpret state law confirm that North Carolina's business judgment rule shields the decisions of bank directors and officers from judicial review provided that they meet three basic requirements: good faith, lack of conflict of interest, and an informed and rational process.

Any analysis of how the North Carolina Supreme Court would interpret this state law issue must begin with holdings of the North Carolina Supreme Court itself. In *Alford*, the court described the business judgment rule as rooted in "the important distinction between…cases involving directors who were allegedly guilty of fraud, breach of trust, or were proceeding *ultra vires*, and those cases 'in which there is no breach of trust, but only error and misapprehension or *simple negligence* on the part of the directors.'" 349 S.E.2d at 47 (quoting *Hawes*, 140 U.S. at 458) (emphasis added).

This description echoes earlier North Carolina Supreme Court precedent. In *Minnis v. Sharpe*, for example, the court explained that corporate "directors are liable for *gross neglect* of their duties, and mismanagement (though not for errors of judgment made in good faith), as well as for fraud and deceit." 162 S.E. 606, 607 (N.C. 1932) (emphasis added) (citations omitted). The court approved the "measure of liability" as articulated by the trial judge in the case then on appeal: "directors are liable if they suffer the corporate property to be lost by *gross inattention* to the duties of their trust and are not relieved of liability because they have no actual knowledge of wrong doing if that ignorance is the result of *gross negligence*." *Minnis*, 162 S.E. at 607 (emphasis added); *see also Sec. Nat. Bank (Tarboro Unit) v. Bridgers*, 176 S.E. 295, 297 (N.C. 1934) (describing gross negligence standard as "safe, sane, and salutary"). In the same vein, the court reaffirmed that a suggestion to a jury that "directors and managing officers are chargeable with an omniscient knowledge of the company's affairs and are liable for damages to third parties resulting from *simple negligence*" was "not the law in North Carolina." *Myers & Chapman, Inc. v. Thomas G. Evans, Inc.*, 374 S.E.2d 385, 394 (N.C. 1988) (emphasis added).

The business judgment rule has been further evaluated by the lower courts of North Carolina in the context of the state statutory standard of care for directors and officers. These statutes establish a duty to act "(1) [i]n good faith; (2) [w]ith the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) [i]n a manner he reasonably believes to be in the best interests of the corporation." N.C. Gen. Stat. §§ 55-8-30, 55-8-42. Acknowledging that this was the *standard of care* for directors and officers, the North Carolina Court of Appeals nevertheless maintained that the *standard of review* by which "[d]irectors may be held personally liable" was "*gross neglect* of their duties, mismanagement, fraud and deceit." *Oberlin Capital, L.P. v. Slavin*, 554 S.E.2d 840, 845 (N.C. Ct. App. 2001) (emphasis added) (citation omitted); *see also F-F Milling Co. v. Sutton*, 175 S.E.2d 746, 748 (N.C. Ct. App. 1970) (same).

The North Carolina Business Court has clarified what is meant by the statutory duty that directors and officers act "[w]ith the care an ordinarily prudent person in a like position would exercise under similar circumstances." N.C. Gen. Stat. §§ 55-8-30, 55-8-42.

> Absent proof of bad faith, conflict of interest, or disloyalty, the business decisions of officers and directors will not be second-guessed *if they are the product of a rational process, and the officers and directors availed*

> *themselves of all material and reasonably available information* and honestly believed they were acting in the best interest of the corporation. The standard of review is predicated on concepts of *gross negligence*.

Custard II, 2010 WL 1035809, at *21 (emphasis added) (citations omitted); *see also Ehrenhaus*, 2008 WL 5124899, at *13. "Director obligations will be judged in the context in which they occur," but if there is no allegation of gross negligence, the statutory standard of care and business judgment rule bar judicial review of good faith, disinterested business decisions made through a rational and informed process. *Custard II*, 2010 WL 1035809, at *19, 26; *see also Custard I*, 2007 WL 2570241, *11 ("No cause of action ... exists for 'negligent management' and there are no cases in North Carolina even intimating that such a cause of action exists.").

The business judgment rule thus creates the "presumption that in making a decision the directors *acted with due care (i.e., on an informed basis)* and in good faith in the honest belief that their action was in the best interest of the corporation." *Green v. Condra*, No. 08-CVS-6575, 2009 WL 2488930, at *8 (N.C. Bus. Ct. Aug. 14, 2009) (emphasis added). To overcome that presumption, a plaintiff "must allege, in other than conclusory terms, that the *board was inattentive or uninformed*, acted in bad faith, or that the board's decision was unreasonable." *Id.* (emphasis added) (citations omitted).

b. North Carolina Follows Delaware's Interpretation of the Business Judgment Rule.

North Carolina's standard of review of gross negligence is consistent with Delaware's interpretation of the business judgment rule. And with good reason:

the courts of Delaware are "generally recognized as an authority in the interpretation of business law" by the North Carolina Supreme Court. *Energy Investors Fund, L.P. v. Metric Constructors, Inc.*, 525 S.E.2d 441, 443 (N.C. 2000); *see, e.g.*, *Meiselman v. Meiselman*, 307 S.E.2d 551, 568 (N.C. 1983) (citing Delaware case law on an issue of corporate law). "The North Carolina courts frequently look to Delaware for guidance on questions of corporate governance because of the special expertise and body of case law developed in the Delaware Chancery Court and the Delaware Supreme Court." *Ehrenhaus*, 2008 WL 5124899, at *9 n.19.

Delaware law requires plaintiffs to plead *gross* negligence—not *simple* negligence—to overcome the presumptions of the business judgment rule:

> The business judgment rule is a presumption that in making a business decision the directors of a corporation *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 standard of director liability under the business judgment rule is predicated upon concepts of gross negligence*."

In re Citigroup, 964 A.2d at 124 (emphasis added) (citations omitted). Although directors and officers must follow a rational and informed process to perform their legal duties, "this obligation does not eviscerate the core protections of the business judgment rule," and "the burden required for a plaintiff to rebut the presumption of the business judgment rule by showing *gross negligence* is a difficult one." *Id.* at 125 (emphasis added).

c. No North Carolina Authority Supports FDIC's Contention That Simple Negligence Overcomes the Business Judgment Rule.

Despite the consistent case law from all levels of North Carolina's court system contrary to its position, FDIC incorrectly argues that a simple negligence standard prevails.

First, FDIC argues that lawsuits against directors and officers by the corporations they serve, or derivative actions by their shareholders or receivers, are held to a lower burden to overcome the business judgment rule. FDIC Br. 36. The weight of this extraordinary argument rests on the slender reed of two superannuated decisions that, upon close analysis, do not support FDIC's position. *See Gordon v. Pendleton*, 162 S.E. 546, 547 (N.C. 1932); *N.C. Corp. Comm'n v. Harnett Cnty. Trust Co.*, 134 S.E. 656, 657 (N.C. 1926). Neither decision required the court to inquire into whether a standard of ordinary or gross negligence applied. *Harnett* involved allegations of the defendant officer's bad faith and willful malfeasance, which uncontroversially deprive officers of the business judgment rule. 134 S.E. at 657. In *Gordon*, the court evaluated the evidence and concluded that the alleged wrongdoing simply did not happen, avoiding any consideration of negligence. 162 S.E. at 547. In contrast, North Carolina court decisions that have specifically discussed what standard of negligence applies, and where that standard was relevant to the outcome of the case, have held that plaintiffs must plead gross negligence to overcome the presumptions of the business judgment rule. *See supra* Part II(B)(2)(a).

Second, FDIC contends that North Carolina's courts would apply a heightened standard of care to *bank* officers and directors. FDIC Br. 36. But no authority supports this argument. FDIC cites *Lillian Knitting Mills Co. v. Earle*, but that decision involved claims by depositors against bank directors for misrepresentations; as such, it addresses allegations of fraud, not negligence. 74 S.E.2d 351, 355-56 (N.C. 1953). Thus, *Lillian Knitting*'s discussion of the standards of bank director liability is mere dicta that "had no bearing on the decision in that case." 1 Russell M. Robinson, *Robinson on North Carolina Corporation Law* § 14.03 n.6 (7th ed. 2009).

FDIC also misreads the Robinson treatise. The treatise merely suggests a higher standard "might" apply, pointing to a New York federal court decision applying *New York law* and a North Carolina state statute that imposes personal liability on bank directors for "*knowing*[]" violations of bank regulatory laws—neither of which indicates that North Carolina permits simple negligence claims for bank director and officers' business decisions. *See id.* § 14.03 & n.5 (citing N.C. Gen. Stat. § 53-82, now codified at N.C. Gen. Stat. § 53C-4-6). Likewise, FDIC inappropriately cites *Custard II*, which in fact concludes, reasonably, that "[d]irector obligations will be judged in the context in which they occur," and that this review is "predicated on concepts of gross negligence." 2010 WL 1035809, at *19, 21.

Nor would the distinction FDIC suggests make sense as a policy matter. Efficiently available credit is the lifeblood of a healthy economy. As explained above, applying a more limited version of the business judgment rule within the banking industry in particular would make credit more costly and restrict credit distribution. As these effects percolate through the economy, they would constrain "venturesome business activity," thereby limiting economic growth and productivity. *See Alford*, 349 S.E.2d at 47 n.5.

3. The North Carolina Legislature Preserved the Common Law Business Judgment Rule.

FDIC cites to out-of-state decisions that it contends "have unanimously concluded that insulating a director from anything but gross negligence impermissibly alters the statutory standard of care." FDIC Br. 39. But FDIC does not explain how these authorities—including at least one that has in substance been overruled by the issuing court—can be relevant for *the law of North Carolina*, and they are not. *See* FDIC Br. 37-40 (citing *FDIC v. Stahl*, 89 F.3d 1510 (11th Cir. 1996) (Florida law); *Hoye v. Meek*, 795 F.2d 893, 896 (10th Cir. 1986) (Oklahoma law); *Shields v. Cape Fox Corp.*, 42 P.3d 1083, 1085 (Alaska 2002)).

FDIC's reliance on *Shields* is particularly misguided. After deciding *Shields*, the Alaska Supreme Court later "clarif[ied]" that the state's statutory standard of care "did not replace, redefine, or codify Alaska's common law business judgment rule" under which "corporate directors in Alaska continue to enjoy … heightened protection … beyond a showing of mere negligence." *Henrichs v. Chugach Alaska Corp.*, 250 P.3d 531, 538 & n.28 (Alaska 2011).

In any event, North Carolina's courts have time and again articulated the applicable standard of review as gross negligence, even while acknowledging the state statutory standard of care. In *Long*, for example, the North Carolina Court of

Appeals, directly contradicting FDIC's argument here, held that N.C. Gen Stat. § 55-8-30 "does not abrogate the common law of the business judgment rule … proper analysis requires examination of [a director's] actions in light of th[ose] statutory protections … and the business judgment rule." 513 S.E.2d at 821; *see also Custard II*, 2010 WL 1035809, at *26.[7]

Notably, the two out-of-state cases that FDIC cites most frequently do not even stand for the principle that a state's statutory standard of care must trump a common law business judgment rule. *See FDIC v. Skow*, 763 S.E.2d 879 (Ga. 2014); *FDIC v. Loudermilk*, 761 S.E.2d 332 (Ga. 2014). In these cases, the Georgia Supreme Court maintained that the business judgment rule continued to protect director and officer business decisions and define the standard of review:

> [T]he business judgment rule is a settled part of our common law in Georgia, and it generally precludes claims against officers and directors for their business decisions that sound in ordinary negligence, except to the extent that those decisions are shown to have been made without deliberation, without the requisite diligence to ascertain and assess the facts and circumstances upon which the decisions are based, or in bad faith.

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7 *Resolution Trust Corp. v. Bernard*, No. 94-CV-475, 1995 WL 17164886, at *12 (M.D.N.C. Aug. 8, 1995), also does not further FDIC's argument. The *Bernard* court merely concluded that North Carolina "*may*" recognize director liability for simple negligence, but found the law "unsettled at best." *Id.* at *11-12.

Loudermilk, 761 S.E.2d at 338.[8] It is Georgia's *common law*, which "reflects a more modest business judgment rule," that allows claims for ordinary negligence when "premised on allegations that a business decision was uninformed or unreasoned." *Id.* at 338.

III. NO COUNTERVAILING POLICY REASONS SUPPORT FDIC'S PROPOSED ORDINARY NEGLIGENCE STANDARD.

FDIC's interpretation of the business judgment rule may protect its own interests, but there is no principled reason why the Court should allow those interests to dictate the rule's application. Instead, allowing FDIC's parochial concerns to resolve the proper standard of care for directors and officers would be anomalous, inefficient, and detrimental, particularly in light of the extensive regulation and supervision of banks by both federal and state regulators.

The business judgment rule serves to align directors' and officers' incentives with shareholders' and society's interest in having corporations take risks where the expected (*i.e.*, prospectively anticipated) return is positive, even though the actual return cannot be predicted with certainty and may (when retrospectively evaluated) turn out to be negative. *See Gagliardi*, 683 A.2d at 1050-52. The rule is necessary to bring the incentives into alignment because "[c]orporate directors ... typically have a very small proportionate ownership interest in their corporations and little or no incentive compensation." *Id.* at 1052. As a result, they enjoy "only

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[8] Notably, *Loudermilk* held that the "business judgment rule applies equally … to corporate officers and directors generally and to bank officers and directors," 761 S.E.2d at 338, undercutting FDIC's contrary argument, *supra* Part II(B)(2)(c).

a very small proportion of any 'upside' gains earned by the corporation on risky investment projects." *Id.* This causes a "stupefying distinction between risk and reward for corporate directors," and means that unless their potential downside liability is appropriately limited, directors and officers will generally engage in "sub-optimal risk acceptance." *Id.*

The business judgment rule realigns incentives by making directors' and officers' downside risk more comparable to their limited upside potential. This facilitates the "creation of corporate value [and] wealth," *First Union*, 2001 WL 1885686, at *7, thereby protecting society and the economy from the "uneconomic consequences" of excessive risk aversion, *Gagliardi*, 683 A.2d at 1052.

FDIC's position would subordinate society's interest in encouraging corporations to take on projects that are likely but not certain to create value to FDIC's own interest in avoiding liability for losses that have already been incurred. As a deposit insurer and receiver for failed institutions, FDIC bears losses when business risks turn out poorly and banks fail—as do shareholders, who lose their invested capital. But unlike shareholders, FDIC does not share in an operating bank's upside potential. Accordingly, FDIC occupies a unique, downside-only position from which it is ill-situated to appreciate the economic rewards realized by proper application of the business judgment rule.[9]

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[9] The deposit-insurance function differentiates FDIC from other receivers and managers of insolvent entities, such as bankruptcy trustees, who do not bear responsibility for the insolvent entities' financial obligations.

Because downside-only stakeholders capture none of the gains from decisions that pay off, their rational preference will always be for the least possible downside (*i.e.*, the lowest-risk decision) even where, on an expected-return basis, greater risk is economically justified and desirable from a societal standpoint. For example, a downside-only stakeholder would prefer to invest $1 in a low-risk project with 50-50 odds of returning positive $2.50 or zero, than to invest its $1 in a higher-risk project with 50-50 odds of returning positive $5.00 or negative $0.10. In terms of overall return, the expected value of the low-risk project is $1.25, while the expected value of the high-risk project is $2.45. The downside-only stakeholder, however, does not evaluate the options in terms of overall return; it ranks them in terms of returns to itself. In this example, the low-risk project has an expected return of zero to the downside-only stakeholder, while the high-risk project has an expected return of negative $0.05. For that reason, the downside-only stakeholder will prefer the low-risk project, despite that project's *lower* overall expected value.

In the aggregate and over time, projects with a higher expected return will return more to society, even though more of them may fail.[10] A downside-only player, however, given the opportunity, would always select the low-risk project and opt for rules encouraging or requiring others to do so. As Judge Posner has

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[10] Shareholders likewise benefit, as they can manage the risk that any single investment or project will fail by diversifying their portfolios. *See Gagliardi*, 683 A.2d at 1052.

explained, stakeholders that "have no claim to the upper tail of the distribution of possible earnings," which downside-only players lack, "do not have the correct economic incentive—to maximize the value of the corporation." Posner, *supra*, at 546. Accordingly, it is predictable and understandable—but not desirable from society's perspective—that FDIC's downside-only position as deposit insurer and receiver leads it to advocate for a rule under which banks would take on less risk than would be economically efficient in the sense of maximizing society's overall wealth.

In any event, FDIC does not need any change in North Carolina law to manage its risk. As the primary regulator of banks chartered by the states that do not join the Federal Reserve System (and with back-up supervisory authority for other institutions), FDIC is empowered to examine individual banks, issue regulations applicable to insured depository institutions, and monitor and enforce safety and soundness standards in the industry. It has all the tools necessary to address its particular concerns without need for any alteration of North Carolina's business judgment rule. Moreover, Congress has expressly directed that it is up to the states—not FDIC—to determine whether to adopt a standard more rigorous than gross negligence. *See* 12 U.S.C. § 1821(k); *Atherton v. FDIC as Receiver for City Savings*, 519 U.S. 213, 216 (1997) (Under § 1821(k), "state law sets the standard of conduct as long as the state standard (such as simple negligence) is stricter than that of the federal statute[,] [which] sets a 'gross negligence' floor.").

Tailoring the North Carolina business judgment rule to FDIC's interest would thus be unwise, unnecessary, and contrary to Congress's expressed intent. It would also be unfair. The recovery available to any claimant on a receivership estate under FDIC's management is "unequivocally ... limit[ed]" to what that claimant could have received through an immediate liquidation minus the receivership's expenses. *See First Ind. Fed. Sav. Bank v. FDIC*, 964 F.2d 503, 507 (5th Cir. 1992);12 U.S.C. § 1821(i)(2). Functionally, this provision immunizes FDIC from shareholder claims for negligent mismanagement during the receivership, precisely the standard FDIC seeks to hold directors and officers to here.

CONCLUSION

FDIC's position has no support in controlling case law or sound public policy and should be rejected by this Court. The decision below should be affirmed.

Respectfully submitted,

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Dated: February 6, 2015

CERTIFICATE OF COMPLIANCE

I hereby certify as follows:

1. This brief complies with the type-volume limitation of Federal Rule of Appellate Procedure 32(a)(7)(B) because it contains 6,9996 words, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii);

2. This brief also complies with the typeface requirements of Federal Rule of Appellate Procedure 32(a)(6) because it has been prepared in a proportionally spaced typeface using Microsoft Word 2007, in 14-point Times New Roman font.

3. Pursuant to Circuit Rule 28A(h), the electronic version of this brief has been scanned for viruses using Sophos Anti-Virus and is virus-free.

Dated: February 6, 2015

/s/ Michael A.F. Johnson
Michael A.F. Johnson

CERTIFICATE OF SERVICE

I hereby certify that on February 6, 2015, I caused the foregoing Brief of Amicus Curiae American Bankers Association to be electronically filed via the Court's CM/ECF System, causing a true and correct copy to be served upon all counsel of record who are registered CM/ECF users.

/s/ Michael A.F. Johnson
Michael A.F. Johnson

Counsel for Amici Curiae

Exhibit A

American Bankers Association®

Member Survey Concerning Scope of Protection Under the Business Judgment Rule

January 2015

Prepared by Benchmarking & Survey Research.

aba.com | 1-800-BANKERS

Table of Contents

Executive Summary

Survey Methodology:

In January 2015, the American Bankers Association (ABA) surveyed its members concerning the legal protections available to bank directors and officers against liability for the outcomes of specific business decisions, such as loan-approval decisions. One of the most important sources of such protection is the "business judgment rule," which provides that courts defer to the judgments of company officials for their business decisions provided that such decisions are reached (i) in good faith, (ii) without conflict of interest, and (iii) through an informed and rational process. The survey was designed to ascertain the practical consequences of changing this standard as applied to bank officers and directors and their decisions on behalf of the bank, as well as other bank activities and practices.

The confidential member survey was conducted via a secure online survey portal. The invitation to complete the survey was distributed by email to the CEOs of 3,486 banks. The CEOs were encouraged to forward the survey to bank directors and officers for completion.

The questionnaire included two sections. Section I addressed concerns of bank directors and officers. Each surveyed director or officer was asked to provide his or her own responses to those questions, and more than one director or officer at each bank could respond. Section II included questions that sought responses based on the bank's institutional perspective and knowledge. Each bank was instructed to submit one completed survey for Section II.

By the response cut-off date, 668 respondents from 445 banks had completed the survey. The overall response rate based on the number of banks was 12.8%. Approximately 86 percent of the respondents were from banks with assets of $1 billion or less.

Executive Summary

Summary of Key Findings—Concerns of Directors and Officers:

- More than two-thirds of the respondents (65.3%) are very concerned about potential personal liability for business decisions they make in their roles as bank directors or officers, with another 31.8% somewhat concerned.
- More than 8 in 10 respondents indicated that a reduction in the legal protection against personal liability for business decisions would adversely affect their willingness to serve as bank directors or officers.
- With respect to the sources of potential personal liability, the respondents appear most concerned about *Lawsuits by the Regulators,* cited by 92.3% of the respondents, followed by *Lawsuits by Third Parties* (80.0%).
- When asked about potential impact resulting from a reduction in protection against personal liability for business judgments, 79.5% of the respondents cited a lower volume of lending to borrowers with no credit history such as new businesses; 76.0% cited a lower volume of lending in underserved market segments; and 74.8% cited higher costs of administering the loan evaluation and approval process.

Executive Summary

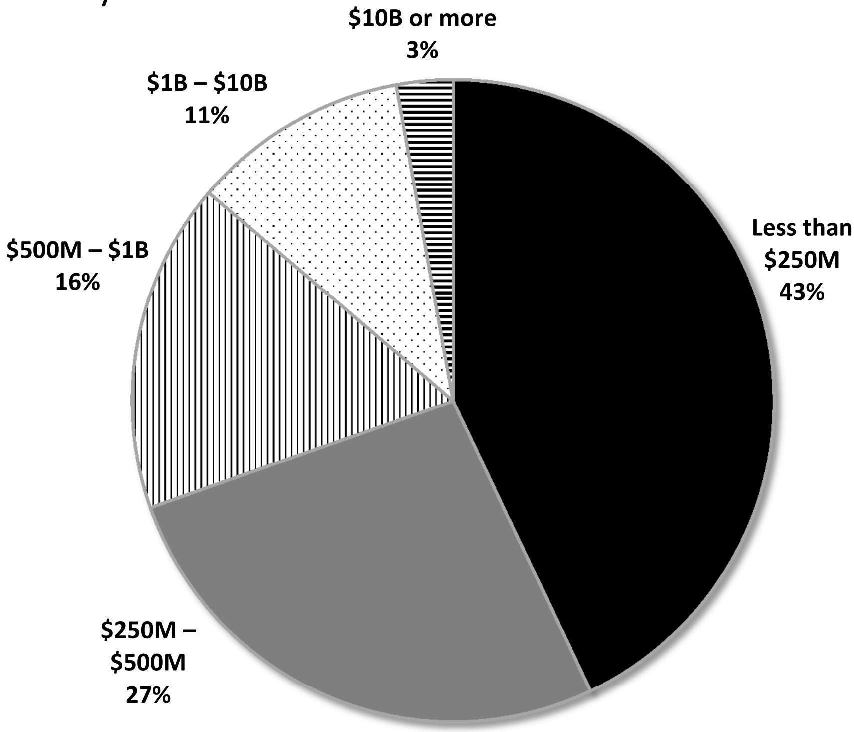
Summary of Key Findings—Institutions' Perspective:

- One in five banks surveyed reported having former directors or officers resign or retire from that position in large part due to fear of personal liability for decisions made in that role. In addition, 4 in 10 banks reported that they are aware of qualified candidates for a director or officer role at the bank having declined to seek or assume that position largely due to a concern about potential liability.
- Surveyed banks reported changes in their D&O liability coverage in the past five years. For example, 85.6% of the respondents reported having increases in the premium amounts. Other commonly noted changes include higher deductible amounts (56.6%) and higher policy limits (45.3%).
- With respect to changes in the scope of banks' D&O coverage, survey responses were mixed, with 31.4% stating "increased," 30.0% stating "decreased," and the remaining 38.6% citing "unchanged."
- Respondents cited the legal environment as the leading factor that contributed to recent changes in the D&O coverage (72.1%), followed by the general conditions in the financial market (65.4%).

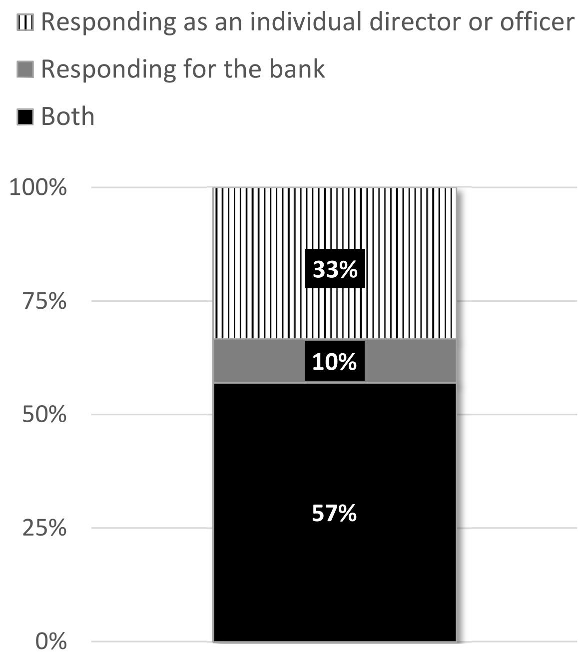
Profile of Survey Respondents

Total Number of Respondents: 668

By Asset Size



By Responding Status

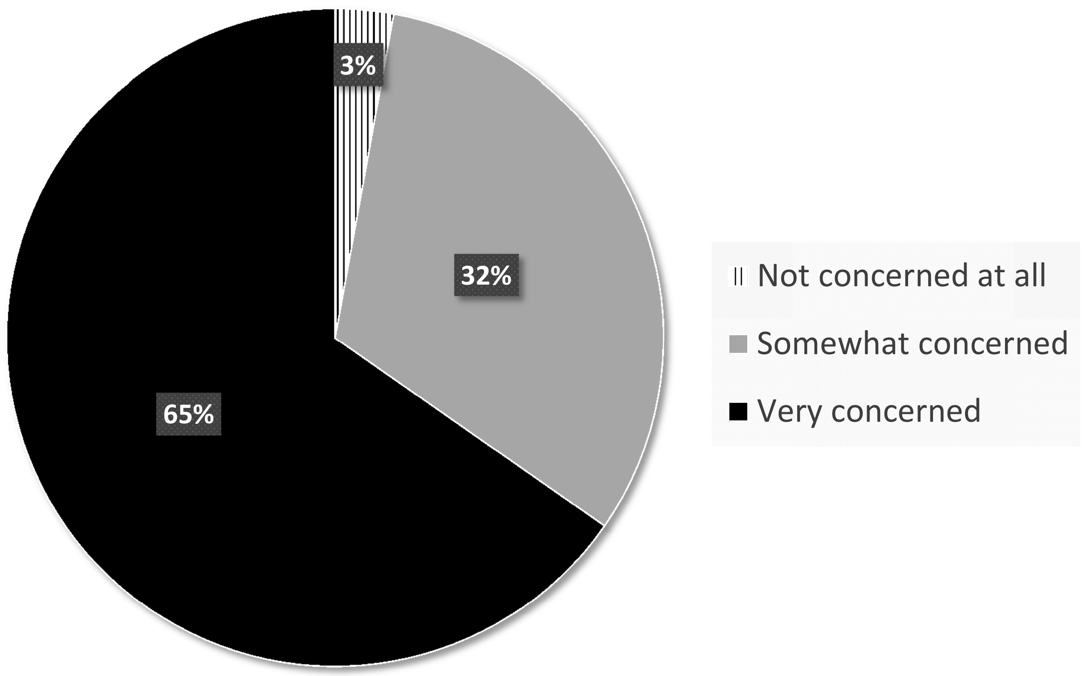


American Bankers Association.

Section I: Bank Director/Officer Questions

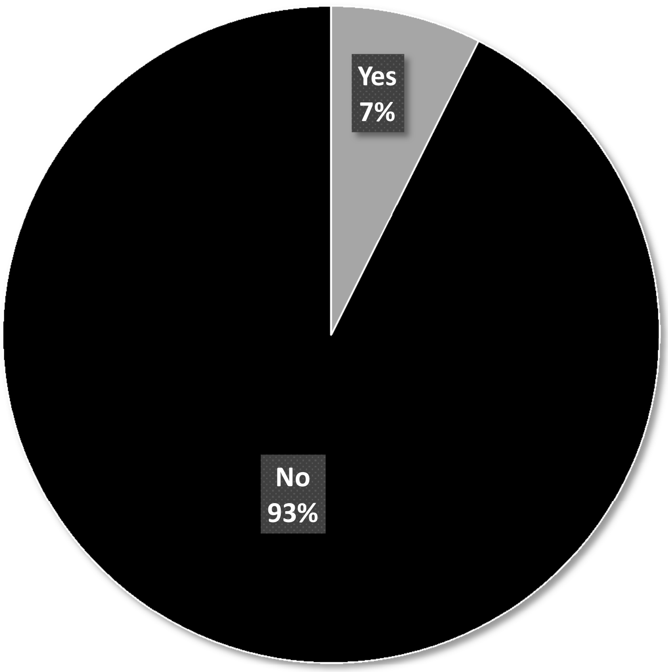
How concerned are you about potential personal liability for business decisions, such as loan-approval decisions, you make in your role as a bank director or officer?

Percentage of Respondents

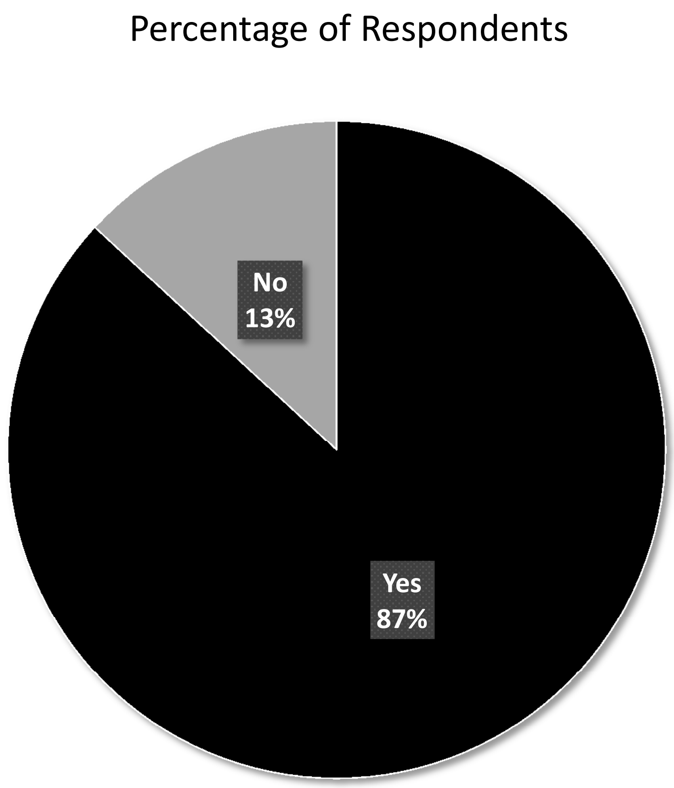


Have you ever declined to serve as a bank director or officer due in part to your concern about potential personal liability? 9

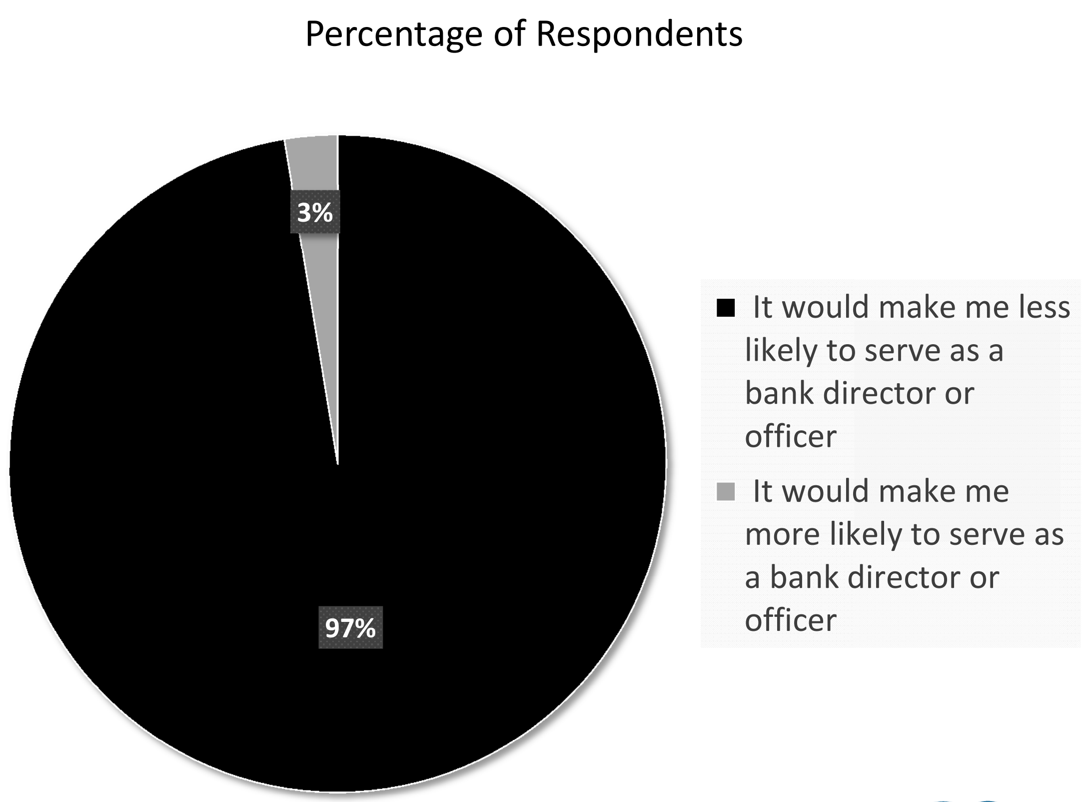
Percentage of Respondents



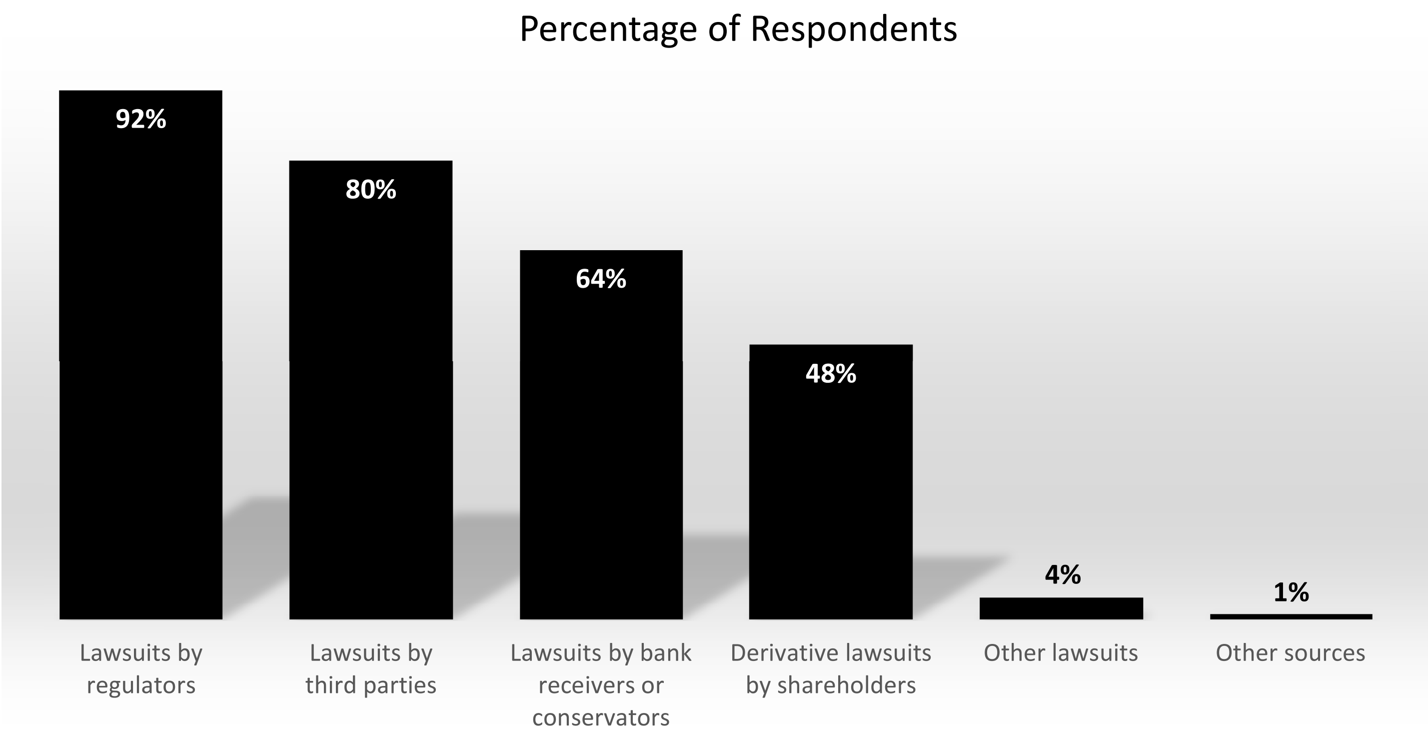
Would a reduction in the legal protection of bank directors and officers against personal liability for business decisions affect your willingness to serve in such a position?



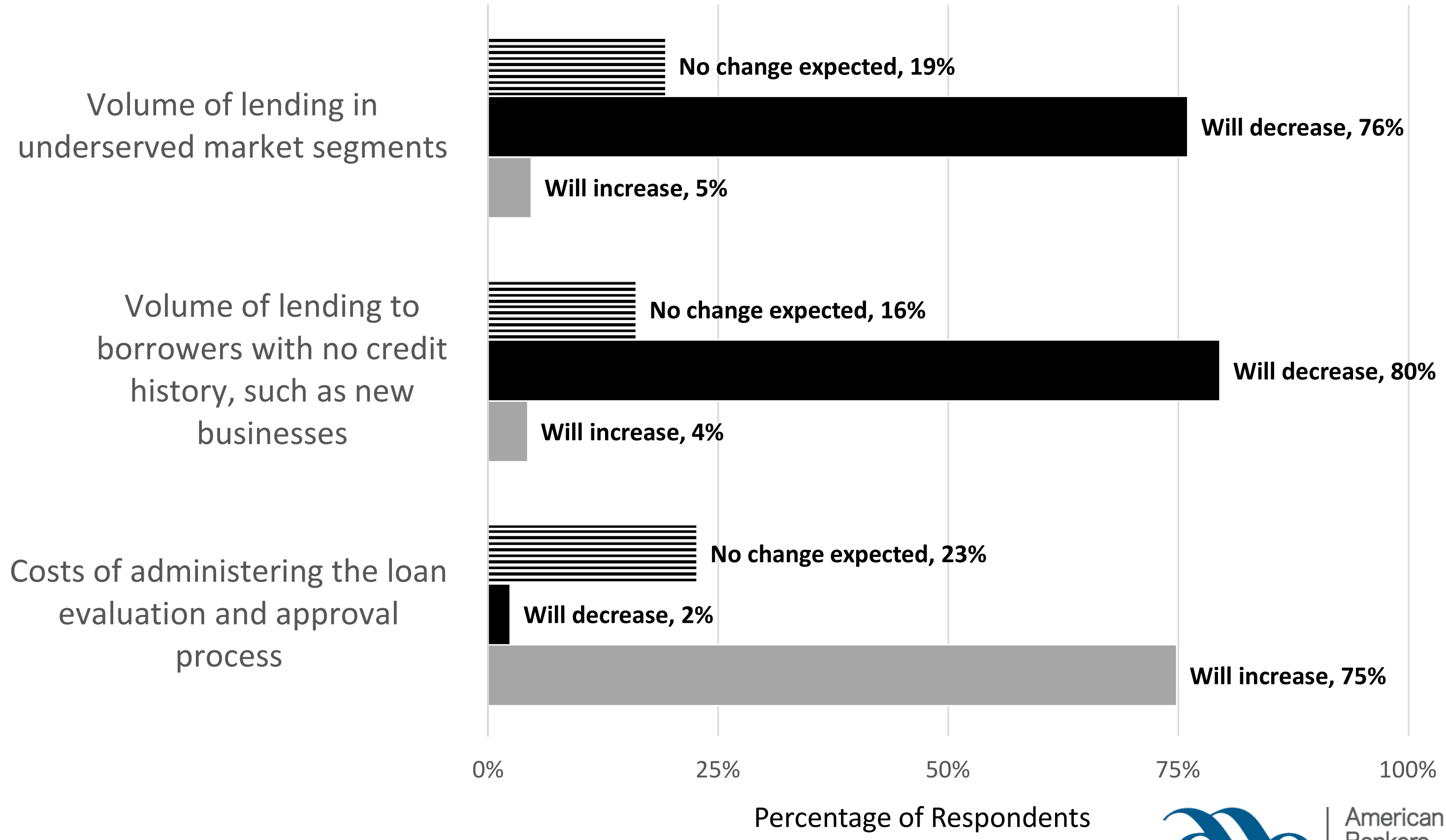
If yes, how would a reduction in the legal protection of bank directors and officers against personal liability for business decisions affect your willingness to serve as a bank director or officer?



What sources of potential personal liability, if any, would affect your decision to serve as director or officer of a bank? (Select all that apply) 12



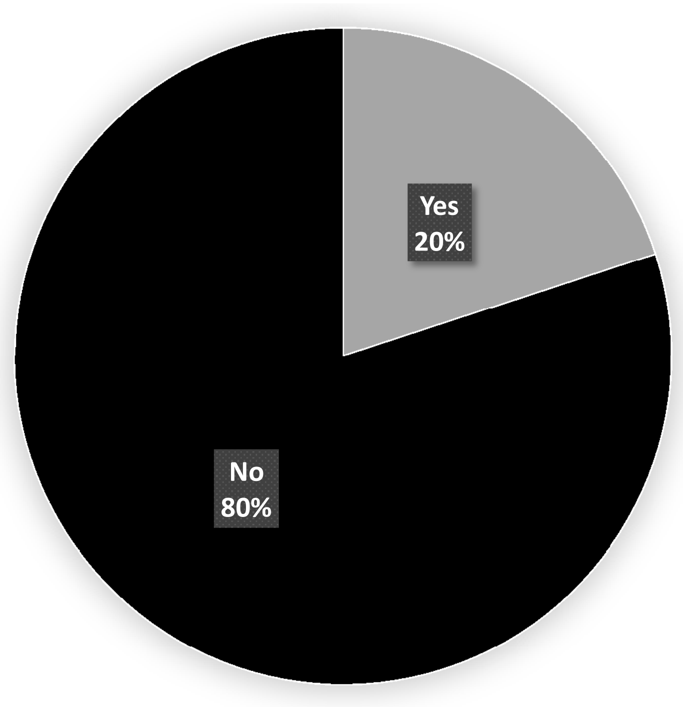
If bank directors' and officers' legal protection from personal liability for business judgments (such as lending decisions) were reduced, but all other relevant factors and procedures remained the same, which if any of the following changes would you expect to see as a result at your bank? (Select all that apply)



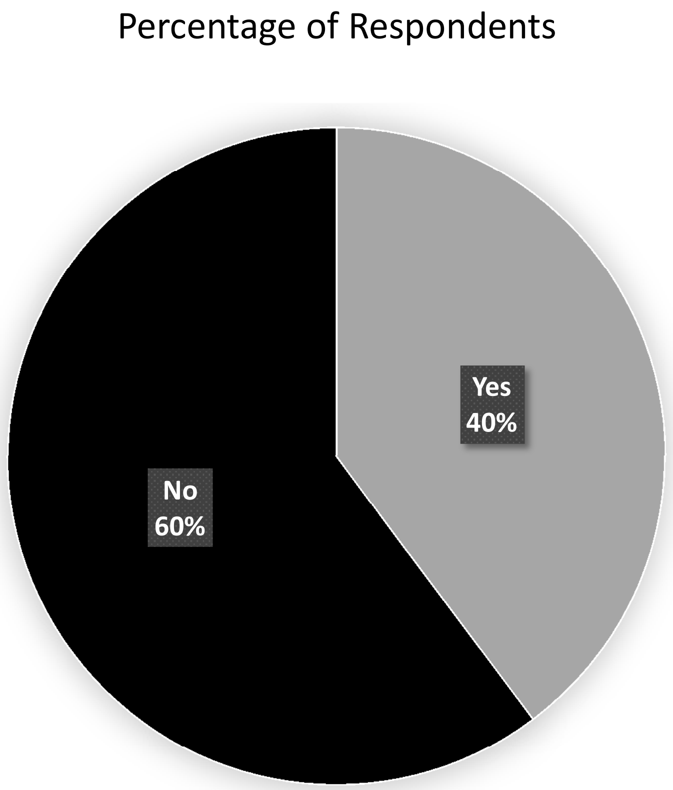
Section II: Institutional Questions

To your knowledge, did any former director or officer at your bank resign or retire from that position in large part due to fear of personal liability for decisions made in that role?

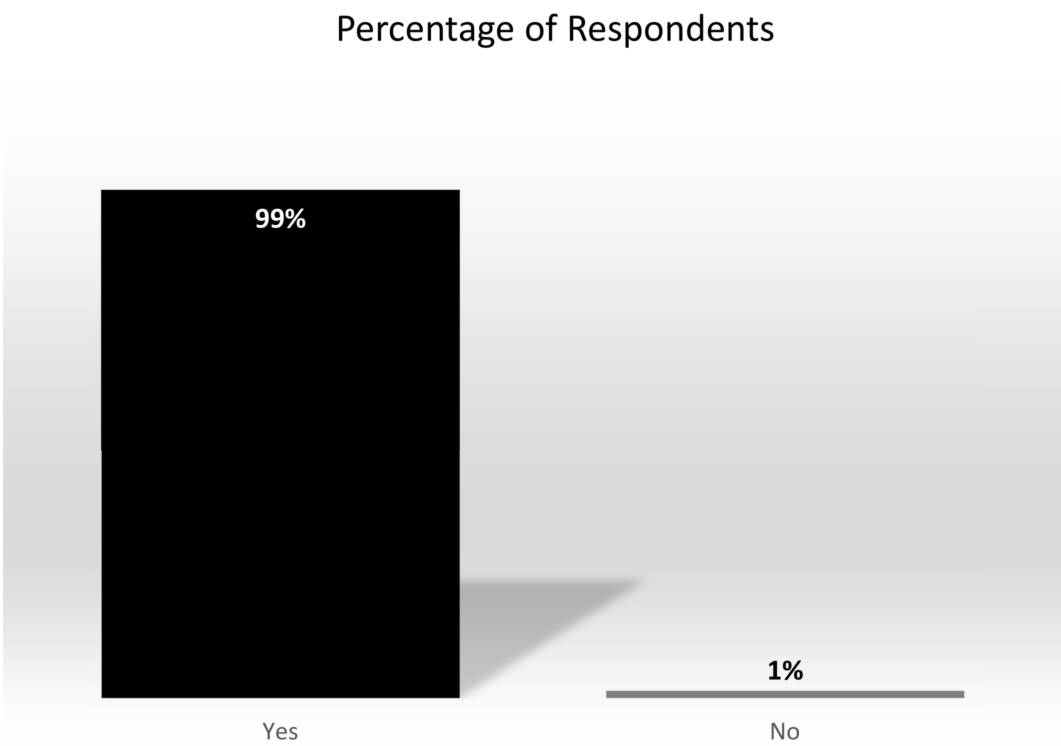
Percentage of Respondents



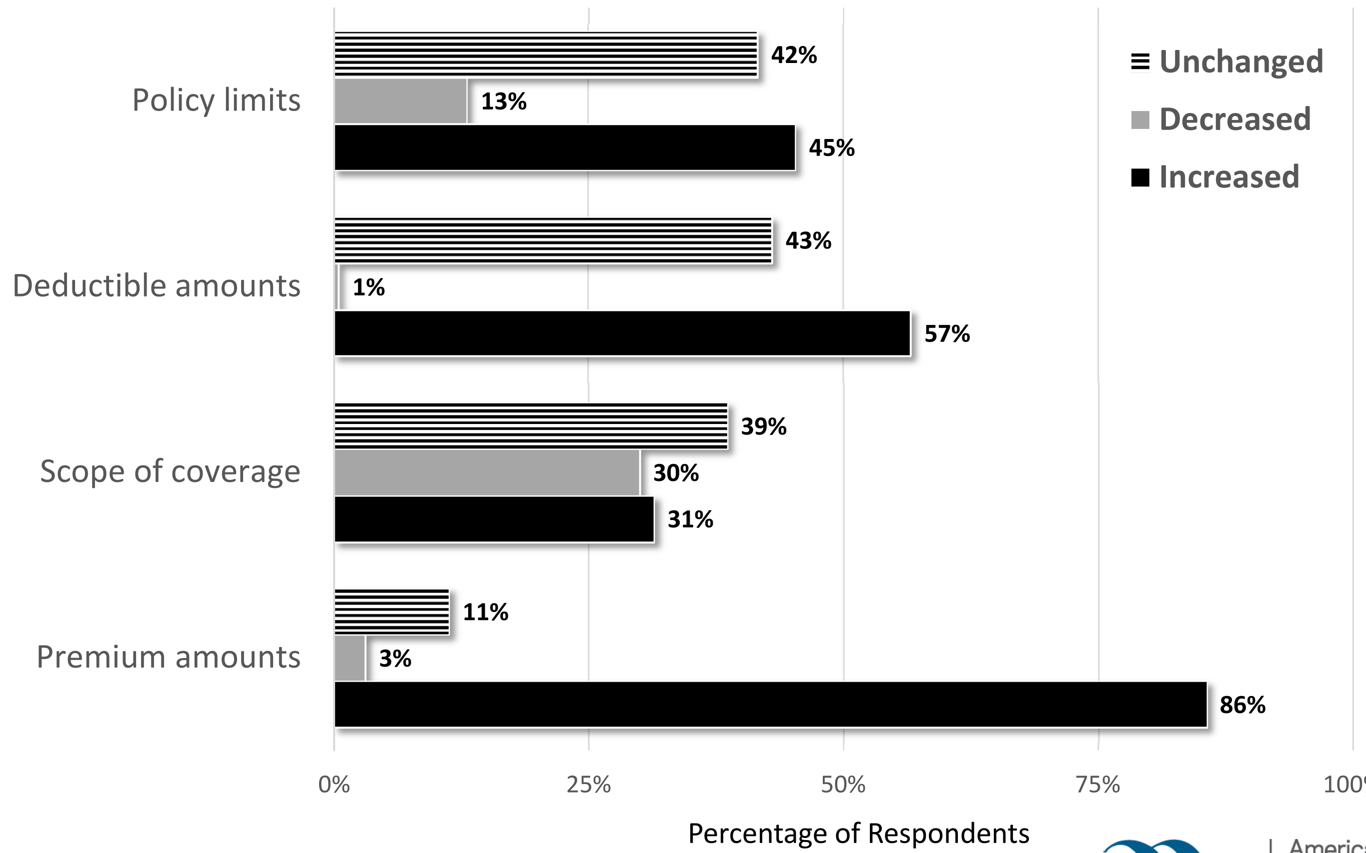
Are you aware of any qualified candidate for a director or officer role at your bank having declined to seek or assume that position largely due to a concern about potential personal liability? 16



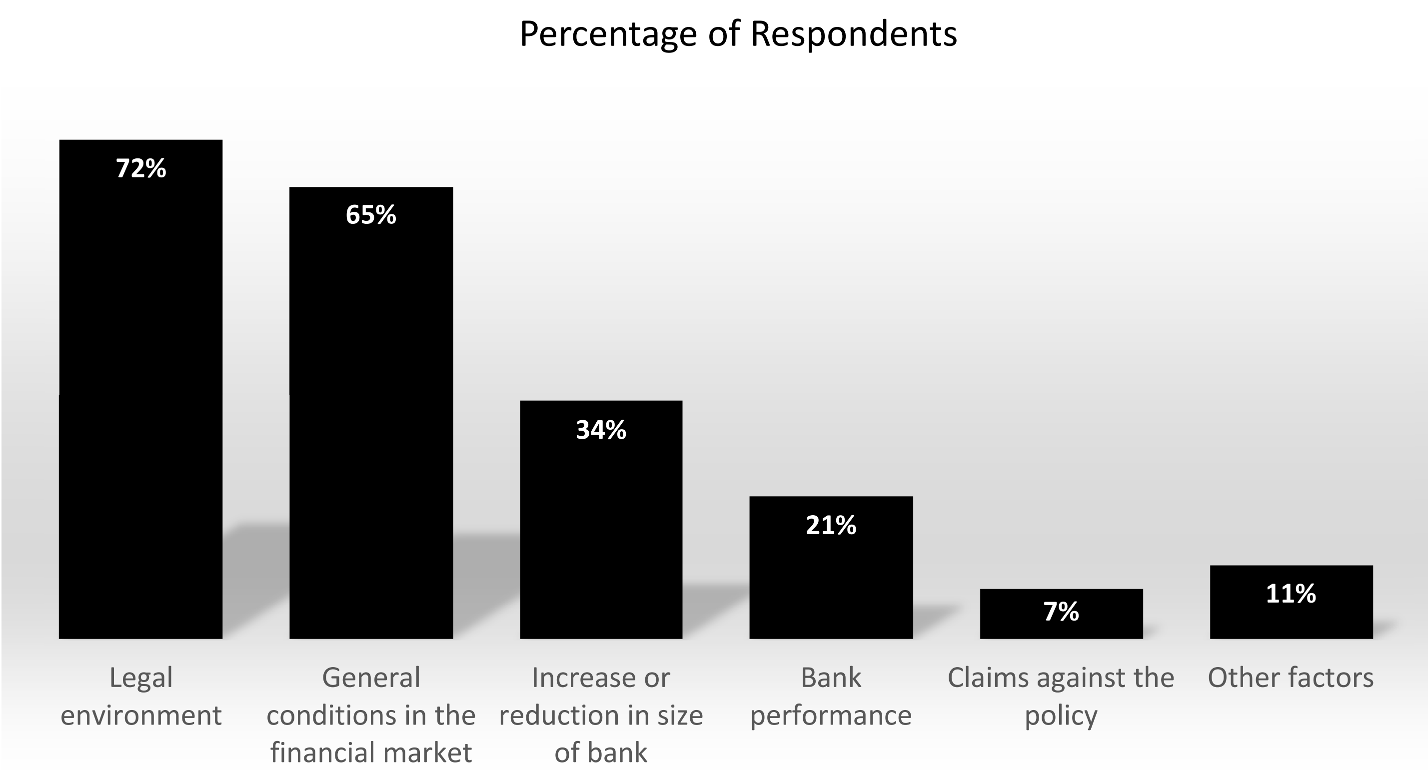
Does your bank have D&O liability coverage?



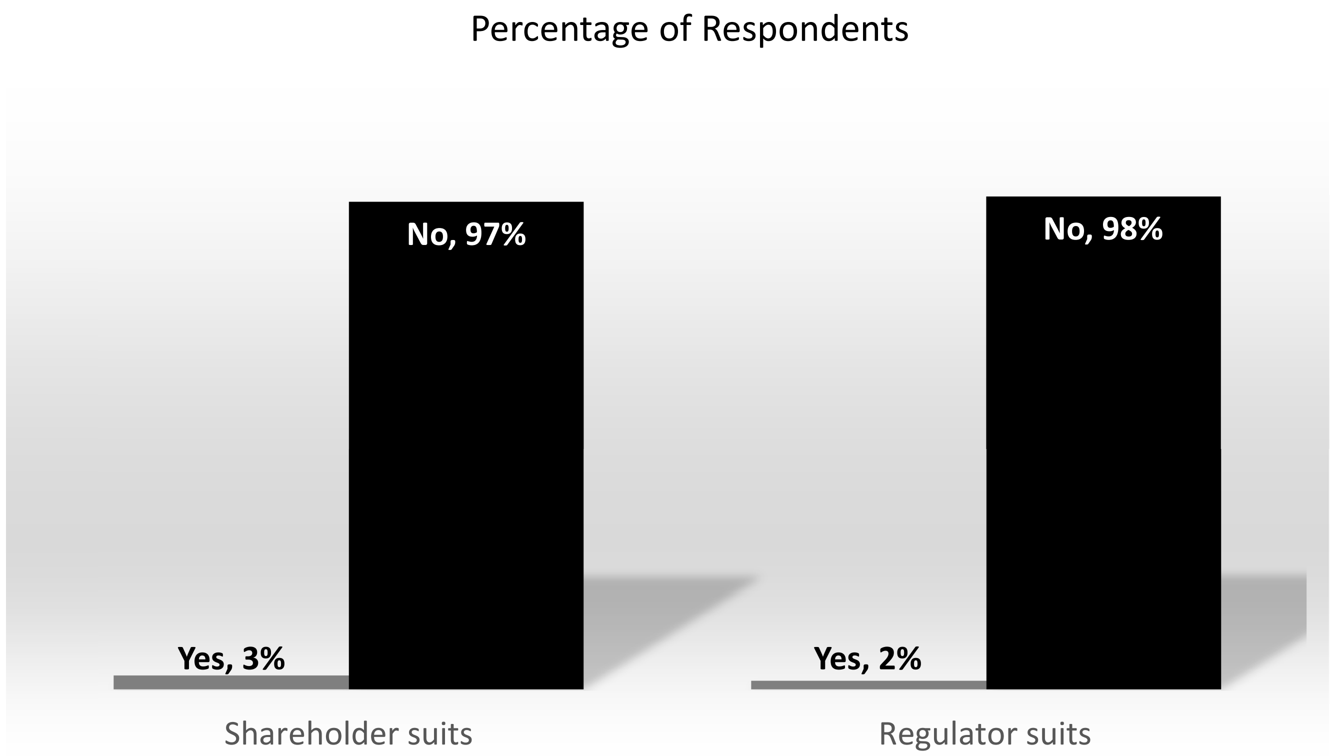
How, if at all, has your bank's D&O coverage changed in the past five years?



If, over the past five years, the terms of your bank's D&O policy changed in any of the ways set forth on the previous page, what factors contributed to those changes? (Select all that apply)



Over the past 5 years, has your bank been subject to any shareholder or regulator suits relating to actions or decisions by directors and officers?



UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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COUNSEL FOR: ____

____as the
(party name)

appellant(s) appellee(s) petitioner(s) respondent(s) amicus curiae intervenor(s)

____
(signature)

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