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; FREDERICK 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 AT WILMINGTON

BRIEF OF *AMICUS CURIAE*
NORTH CAROLINA COMMISSIONER OF BANKS

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STATEMENT PURSUANT TO FED. R. APP. P. 29(c)(4)

The North Carolina Commissioner of Banks (the "NCCOB") charters and regulates North Carolina state-chartered banks under the authority granted in N.C. General Statutes Chapter 53C. The Commissioner is assisted in the performance of his duties by the Office of the Commissioner of Banks, established pursuant to N.C. Gen. Stat. § 53C-2-3 (2014).

The NCCOB closed the bank at issue in this matter in June 2009 and appointed the FDIC as receiver. As the primary regulator of North Carolina state-chartered banks, the NCCOB evaluates the performance of bank directors across the State. The NCCOB is concerned that misapplication of the North Carolina standards of director liability will result in a dearth of qualified individuals willing to govern North Carolina banks.

All parties have consented to the filing of this brief in accordance with Federal Rule of Appellate Procedure 29(a). The NCCOB has authority to file this brief pursuant to Federal Rule of Appellate Procedure 29(a) and N.C. Gen. Stat. § 53C-2-2 (2014).

STATEMENT PURSUANT TO FED. R. APP. P. 29(c)(5)

Pursuant to Federal Rule of Appellate Procedure 29(c)(5), the North Carolina Commissioner of Banks states the following:

(A) Neither counsel for Plaintiff-Appellant nor counsel for Defendants-Appellees authored any portion of this brief;

(B) Neither the North Carolina Commissioner of Banks nor the Office of the Commissioner of Banks has received any funding for the preparation or submission of this brief from any party or their counsel; and

(C) No person contributed money that was intended to fund preparation or submission of this brief.

SUMMARY OF THE ARGUMENT

The business judgment rule is and has been a substantial part of North Carolina jurisprudence regarding judicial evaluation of director conduct. North Carolina courts do not apply a special standard to bank directors; the now-familiar duty of care applicable to corporate directors and officers applies with equal force to the management of financial institutions in this State. Judicial application of the corporate duty of care is tempered by the business judgment rule.

Bank directors in North Carolina are only **personally** liable for bad faith, self-dealing, or reckless disregard of their duty of care in managing the affairs of a bank. Imposing personal liability on bank directors based on a simple negligence standard is not only contrary to North Carolina law, but it will have a detrimental impact on North Carolina banking by reducing the availability of qualified directors and paralyzing bank directors already in place. Recognizing that bank directors – like all other corporate directors – are not soothsayers is vital to the continued high performance of the North Carolina banking industry.

ARGUMENT

I. Introduction.

The North Carolina Commissioner of Banks' interest in this matter is simple: to preserve the proper scope of the business judgment rule as applied to directors and officers of North Carolina state-chartered banks. As the primary regulator of state-chartered banks in North Carolina, the NCCOB is concerned that a simple negligence standard will inhibit bank directors and officers from successfully operating banks in this State and will ultimately result in the State's inability to attract talented leadership to North Carolina banking institutions.

To be clear, the NCCOB expects bank management to draft and implement prudent and rational bank policies. The NCCOB warns all banks under his supervision to manage the banks with a long-term plan. The NCCOB frequently recommends best practices in the course of exercising its regulatory authority. Despite these high expectations, the NCCOB does not expect bank directors to be soothsayers in the financial marketplace.

North Carolina courts have historically respected the business judgment of corporate managers, including directors and officers of banks. Courts in this State have used a variety of formulations to describe what has become known as the business judgment rule. Simply stated, "[d]irectors must have the freedom to take risks and the power to manage the business without undue interference from shareholders or the courts. That freedom is achieved by protection from liability for good faith errors in judgment and deference from the courts in business decisions." *First Union Corp. v. Suntrust Banks, Inc.*, 01 CVS 10075, 2001 NCBC LEXIS 7, at *17 (N.C. Super. Ct. Aug. 10, 2001).

II. The North Carolina Business Corporations Act and Common Law Set the Appropriate Standard for Bank Director Liability.

The North Carolina Business Corporations Act contains a familiar formulation of the director's duty of care: A director must discharge his duty as a director (1) in good faith, (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and (3) in a manner he reasonably believes to be in the best interests of the corporation. N.C. Gen. Stat. § 55-8-30(a) (2014). A director is not personally liable for actions taken in compliance with Section 55-8-30(a). N.C. Gen. Stat. § 55-8-30(d) (2014).

a. The North Carolina Business Corporations Act Incorporates the Business Judgment Rule.

The Business Corporations Act "does not abrogate the common law of the business judgment rule." *State ex. rel. Long v. ILA Corp.*, 132 N.C. App. 587, 601, 513 S.E.2d 812, 821 (1999) (quotation omitted). As a result, "proper analysis of" a director's decisions "requires examination of defendant's actions in light of the statutory protections in [the N.C. Business Corporations Act] and the business judgment rule, either or both of which could potentially insulate him from liability." *ILA Corp.*, 132 N.C. App. at 601-02, 513 S.E.2d at 821 (affirming trial court's conclusion that defendant director of failed insurance company was not entitled to protection of the business judgment rule because director implemented "a plan to benefit himself and his interests at the expense of" the company).

The business judgment rule counsels courts to avoid evaluating director decisions with the aid of hindsight. Instead, courts focus on the process by which a particular decision is reached and will not inquire further into the wisdom of a particular course of action, unless that course appears plainly irrational. North Carolina courts recognize that:

> "[C]ompliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests. To employ a different rule – one that permitted an 'objective' evaluation of the decision – would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions."

State ex rel. Comm'r Ins. v. Custard, 06 CVS 4622, 2010 NCBC LEXIS 9, at *61 (N.C. Super. Ct. Mar. 19, 2010) (quoting *In Re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967-68 (Del. Ch. 1996)).

In other words, "the business judgment rule protects corporate directors from being judicially second-guessed when they exercise reasonable care and business judgment." *ILA Corp.*, 132 N.C. App. at 602, 513 S.E.2d at 822 (quotation omitted).

b. The Statutory and Common Law Standard of Care Applies Equally to Bank Directors.

Between 1935 and 2012, N.C. Gen. Stat. § 53-82 set a high threshold for personal liability of bank directors: "Any director of any bank who shall knowingly violate, or who shall knowingly permit to be violated by any officers, agents, or employees of such bank, any of the provisions of this Chapter shall be held personally and individually liable…." In 2012, the North Carolina General Assembly modernized the banking statutes and revamped many of the provisions that had governed banking in North Carolina since the 1930s.

Today, the standard of conduct for bank directors is contained in N.C. Gen. Stat. § 53C-4-6, titled "Liability of Directors." This provision of the banking laws expressly adopts the standard applicable to all other corporate directors in North Carolina: "The standard of conduct for directors shall be as set forth in G.S. § 55-8-30." N.C .Gen. Stat. § 53C-4-6(a). This section was not intended to dramatically alter the standard of care applicable to bank directors by reducing it to simple negligence. Rather, the goal of Section 53C-4-6 was to codify long-understood ideas of bank organization and management responsibility.

Further, North Carolina court decisions have applied the business judgment rule to bank directors. In a very early decision, the North Carolina Supreme Court declined to second-guess the decisions of directors in a suit brought by stockholders of a bank against its directors for negligent management of a loan. *Braswell v. Pamlico Ins. & Banking Co.*, 159 N.C. 628, 75 S.E. 813 (1912). In affirming dismissal of the stockholders' complaint, the North Carolina Supreme Court observed that bank directors are obligated to exercise judgment in managing the bank, but are not guarantors of its success:

> Directors of corporations are not guarantors that they will make no mistake in the management of the corporate business. They do not insure the corporation against loss arising either from their own honest mistakes or from the mistakes of subordinate officers. They are required to exercise reasonable care and business judgment, but nothing further than this.

Braswell, 159 N.C. at 631, 75 S.E. at 631 (1912); *see also Gordon v. Pendleton*, 202 N.C. 241, 162 S.E. 546 (1932) (dismissing plaintiff-stockholders' claim against directors of a state-chartered bank for negligently making loans for reasons substantially similar to the modern-day business judgment rule).

The North Carolina Business Court[1] has more recently applied the business judgment rule to another major financial player in North Carolina, the insurance

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[1] The North Carolina Business Court is a special forum of the general trial court division in North Carolina. Cases are removed on request of one or both parties from the general civil docket and assigned to a special Superior Court Judge. Only

industry. Much like bank directors, insurance directors are required to assess and manage financial risk. In *State ex rel. Comm'r Ins. v. Custard*, the North Carolina Business Court applied the business judgment rule to directors of an insolvent insurance company and granted summary judgment in favor of the directors on the Insurance Commissioner's claims for breach of fiduciary duty. 06 CVS 4622, 2010 NCBC LEXIS 9 (N.C. Super. Ct. Mar. 19, 2010). The Business Court declined to question managerial decisions "about what policies to write, what premiums to charge, and how much insurance to write without reinsurance," because those decisions were "quintessential business judgments…." *Id*. at 64. The Court held that, in order to overcome the business judgment rule, the Commissioner was obliged to show "that the officers and/or directors displayed a conscious indifference to risks in the face of clear signals of the existence of problems likely to lead to insolvency." *Id*. at 68.

This is not to suggest that bank directors and officers are or should be insulated from bad acts. To the contrary, bank directors are, like other corporate directors, personally liable for fraud, bad faith, and gross mismanagement. Reckless or conscious disregard of the consequences of a course of conduct in the management of a bank is actionable in this State. Although North Carolina law supports imposing

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complex business cases meeting certain statutory requirements are eligible for removal. *See* N.C. Gen. Stat. § 7A-45.4 (2014).

personal liability on directors for gross mismanagement, application of the business judgment rule allows bank directors to act in good faith without fear of being harshly judged in hindsight by courts.

III. <u>Imposing Personal Liability for Simple Negligence Will Have a Deleterious Effect on Banking in North Carolina.</u>

Imposing personal liability on bank directors based on a simple negligence standard will have a detrimental impact on North Carolina banking for several reasons. First, an increased risk of personal liability in the banking sector will drive qualified individuals away from banking and into other corporate management roles. Second, application of a simple negligence standard without the benefit of the business judgment rule is likely to produce the unintentional consequence of paralyzing existing bank management.

a. Applying a Simple Negligence Standard Will Dissuade Competent Individuals From Managing Banks Because of Heightened Personal Risk.

Imposing a simple negligence standard on bank directors will jeopardize the ability of North Carolina state-chartered banks to retain skilled directors. Because of the increased potential for personal liability in the event of an error, participation in bank management will become the pariah of corporate directorships. The quality, not to mention number, of directors willing to join the industry will decline, directly impairing the ability of existing North Carolina banks to prosper. What rational actor would choose a bank directorship over a non-regulated corporate directorship, knowing that he or she will be personally responsible for the success of the bank? The simple negligence standard fails to adequately balance the needs of proprietary success with the regulatory need for prudent management. Without the business judgment rule, that standard sets the threshold for liability too low. This standard should not be specially applied to bank directors.

The North Carolina Business Court expounded on this issue succinctly in 2009:

> The corporate structure requires competent directors willing to serve. In order to attract competent directors it is only fair that we judge their conduct according to the circumstances in which they must make decisions. Those circumstances include the fact that they often have to act without full information. **They do not have control over the business environment that can affect the business decisions they make.** The business environment is constantly changing and courts, not as knowledgeable as businesswomen when it comes to operational business decisions, thus should defer to their business judgment. While we want to set high aspirational goals (standards of conduct) for directors, it is fundamentally fair to review their conduct on a less demanding level because of the circumstances in which they are called upon to act.

Custard, 2010 NCBC LEXIS 9 at *42-43 (quotation omitted) (emphasis added). If banking is to flourish in North Carolina, "the courts must not discourage qualified and capable people from serving as directors and taking risks." *First Union Corp.*, 2001 NCBC LEXIS 7 at *17.

b. The Simple Negligence Standard May Paralyze Existing Bank Management.

A simple negligence standard without the benefit of the business judgment rule has the potential to weaken existing bank management by binding up decisions in the impossible pursuit of perfection. In other words, in meeting the simple negligence standard, bank management will be hard-pressed to justify growth strategies or develop new lines of business because there will always be additional information, particularly as the merits of the plan are vetted by the market. Prudent innovation is key to the banking industry's future, but imposing an untampered, simple negligence standard on bank directors will stifle the industry. Instead of producing a more attentive and vigilant board, a simple negligence standard for personal liability is likely to produce an over-conscientious board along with a bank that is unable to grow.

CONCLUSION

While the closure of a bank is always an unfortunate and unwelcome event, failure itself should not lead to the conclusion that directors failed to make rational decisions in the management of the institution. Application of the business judgment rule strikes the proper balance between judicial respect for corporate decision-making and director accountability. Because imposition of a simple negligence standard will have a deleterious effect on the North Carolina banking industry, the NCCOB encourages this Court to apply the business judgment rule to foreclose claims of simple negligence against bank directors and officers, in the absence of bad faith or self-dealing.

This the 6th day of February, 2015.

Respectfully submitted,

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I certify that on the 6th day of February 2015, the foregoing document was served on all parties or their counsel of record through the CM/ECF system if they are registered users or, if they are not, by serving a true and correct copy at the addresses listed below:

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/s/ Katherine M.R Bosken
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UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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