UM Business Law Newsletter

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Front Row (Left to Right): *3L Aaron Spearman, 3L Justin Bouchard, 2L Brennan Black, Professor Mercer Bullard* ***Back Row:*** *2L Marie Wicks, 3L Walt Montgomery, 3L Brian Stuart*

Letter from the Editor

Welcome to the UM Business Law Newsletter

We are excited to release our First Edition for 2015. We strive to provide you with articles that you can use in your daily practice on current issues concerning business law. With a few exceptions, each article is co-written with a practicing attorney who offers his or her own expertise. In an effort to comply with University policy, we have changed the name from *The Ole Miss Business Law Reporter* to the *UM Business Law Newsletter.*

We would like to congratulate our new member, Austin Jackson, for winning our summer competition for best article. Austin's article is included in this publication and was previously published by *The Mississippi Business Law Reporter*.

We dedicate this first issue to the founders of this publication. Without your hard work to lay the foundation this publication would not have been possible. We would also like to give a special thanks to our faculty advisors Professor and Director of the Business Law Institute Mercer Bullard and Professor John Czarnetzky.

We plan to publish two more editions before the end of the school year. Additionally, we will host the Second Annual Business Law Conference. The conference will take place, April 3rd at the Historic Fairview Inn in Downtown Jackson, MS. Attorneys, professors and students will present on the areas they researched for publication including topics on bankruptcy, banking, and tax law combined with 3 hours of CLE credits. We are also privileged to have Secretary of State, Delbert Hosemann as our keynote speaker. To register for the conference and reserve your seat for lunch, please visit us at www.umbusinesslaw.com/annual-conference/

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As always, thank you for reading!

Walt Montgomery

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Loughrin v. United States: Clarifying the Reach of the Federal Bank Fraud Statute

By: Austin Jackson

Previously Published *The Mississippi Business Law Reporter*

Austin Jackson is a second-year law student from Clinton, MS. In addition to serving on the Ole Miss Business Law Reporter, he is also a member of the Ole Miss Moot Court Board, the Dean's Leadership Council and the Black Law Student Association. He received the Mississippi Business Law Newsletter Award for his article titled Loughrin v. United States: Clarifying the Reach of the Federal Bank Fraud Statute, which was published in the Fall 2014 edition of the Mississippi Bar's Business Law Reporter. Austin graduated with honors from the University of Southern Mississippi with a B.A. degree in English. He was also inducted into the 2012-2013 Southern Miss Hall of Fame. Upon graduation, Austin plans to practice corporate law.

The U.S. Supreme Court recently held that an individual can commit bank fraud without actually intending to defraud a bank.[1] In a unanimous ruling supported by split reasoning, the Court explained that mere intent to obtain property held by the bank while attempting to defraud someone else is sufficient for conviction under the statute.[2] This holding has far-reaching effects as it may substantially expand both the scope of bank fraud prosecutions and federal jurisdiction over traditional state criminal charges—a longstanding pattern that is likely to continue. Without necessarily extending the statute's reach to every fraud scheme that involves payment by check, this holding nevertheless increases the tools available to prosecutors in white-collar crimes.

The factual narrative of *Loughrin* involves a fairly unsophisticated check-cashing scheme. Kevin Loughrin, the Petitioner, stole checks from residential mailboxes as he went door-to-door pretending to be a Mormon missionary.[3] Over several months, he altered the checks and eventually used them to purchase merchandise at a Target store for amounts as much as $250.[4] This routine state-like criminal activity remarkably resulted in federal criminal charges. Federal authorities indicted Loughrin and charged him with six counts under 18 U.S.C. § 1344(2)—one for each of the altered checks tendered to Target—under the federal bank statute, which makes it a crime to knowingly execute a scheme to acquire property owned by or under the custody of a bank "by means of false or fraudulent pretenses."[5]

Loughrin argued that a conviction for bank fraud under Section 1344(2) requires proof of specific intent to defraud the banks on which the checks were drawn.[6] He maintained that the statute did not apply to his conduct because he intended to defraud Target, rather than a bank.[7] Loughrin claimed support in (1) similar language in the mail fraud statute and (2) federalism principles.[8] The district court rejected his argument and instructed the jury that it could convict Loughrin if it found that in offering the fraudulent checks to the merchant, he knowingly executed (or attempt-

1 *Loughrin v. United States*, 134 S.Ct. 2384, 2397 (2014).

2 *Id.* at 2389.

3 *Id.*

4 *Id.*

5 18 U.S.C. § 1344(2).

6 *Loughrin*, 134 S.Ct. at 2388.

7 *Id.*

8 *Id.* at 2390.

ed to execute) a scheme to obtain money or property from the banks on which the checks were drawn.[9] The jury convicted Loughrin on all six counts and the Tenth Circuit affirmed, reasoning that a finding of intent to defraud a bank is only necessary under Section 1344(1) of the federal statute, but not Section 1344(2).[10]

Federal courts have been split on the intent to defraud a bank issue.[11] The First, Sixth, Ninth, Tenth, and Eleventh Circuits have found that intent to defraud a bank is unnecessary for a 1344(2) conviction.[12] The Second, Third, Fifth, Seventh, and Eighth Circuits have required proof of an intent to (1) defraud a bank and/or (2) harm the bank to be a prerequisite for a conviction under Section 1344.[13] This circuit split likely led to the Court taking this case.

The sole issue on appeal was whether an individual could commit bank fraud without intending to defraud a financial institution.[14] The Court relied heavily on the statutory text in ruling that proof of intent to defraud a bank is not required for a 1344(2) conviction.[15] The Court explained that while Section 1344(1) clearly requires an intent to defraud a financial institution, "to read [Section 1344(2)], following the word 'or,' as somehow repeating that requirement even while using different words, is to disregard what 'or' customarily means."[16] The Court found that interpreting Section 1344(2) to require intent to defraud a bank would be redundant. Simply intending to defraud a store (or any non-bank) is sufficient. Thus, the necessary proof of "fraudulent, pretenses, representations or promises" was not limited to banks. Section 1344(2) requires the government to show that the money was to be obtained by means of the fraud, not that the bank must be defrauded. Because checking accounts are under the custody or control of a financial institution, check fraud committed without specific intent to defraud a bank is actionable under the statute. In his concurrence, Justice Alito agreed that intent to defraud need not be proved, but would have gone even further, stating there is no intent requirement at all because Congress clearly intended "knowingly" to serve as the relevant mens rea.[17]

The Court rejected Loughrin's argument that the interpretation of Section 1344 interpretation should be analogous to the Court's interpretation of similar language in the mail fraud statue, which enumerates only one offense that requires proof of specific intent to defraud. Justice Kagan explained that "notable textual differences" between the statutes prohibit such a reading because, in this case, the legislature's organization of Subsection (1) and (2) "indicat[es] that they have separate meanings."[18]

The Court also rejected Loughrin's federalism argument that the Government's broad reading of Section 1344 converts every fraud involving a check into a federal offense and encroaches on the criminal jurisdiction of the states. The Court explained that the "by means of" term in the provision narrows the scope of Section 1344(2) and prevents such a conversion.[19] The defendant must acquire (or attempt to acquire) the bank's property "by means of" the misrepresentation.[20] This requirement is satisfied when the false statement or misrepresentation "is the mechanism naturally inducing a bank (or cus-

9 *Id.* at 2388.

10 *Id.*

11 *See United States v. Nkansah*, 699 F.3d 743, 762 (2d Cir. 2012) (discussing the difference of opinion among Circuits).

12 *See United States v. McNeil*, 320 F.3d 1034, 1038 (9th Cir. 2003); *United States v. De La Manta*, 266 F.3d 1275, 1298 (11th Cir. 2001); *United States v. Everett*, 270 F.3d 986, 991(6th Cir. 2001); *United States v. Kenrick*, 221 F.3d 19, 27 (1st Cir. 2000) (en banc); *United States v. Sapp*, 53 F.3d 1100, 1103 (10th Cir. 1995).

13 *See United States v. Staples*, 435 F.3d 860 (8th Cir. 2006); *United States v. Thomas*, 315 F.3d 190, 200 (3d Cir. 2002); *United States v. Odiodio*, 244 F.3d 398, 401 (5th Cir. 2001); *United States v. Lalije,* 184 F.3d 180, 189 (2d Cir. 1999); *United States v. Davis*, 989 F.2d 244, 246-47 (7th Cir. 1993).

14 *Loughrin*, 134 S.Ct. at 2389.

15 *Id.*

16 *Id*. at 2390.

17 *Id.* at 2397.

18 *Id*. at 2391.

19 *Id*. at 2393.

20 *Id.*

todian of bank property) to part with its money."[21] Thus, not every instance of fraud involving a check is actionable under the statute. A Section 1344(2) violation is triggered when the false statement induces the bank to part with its property.

The Court presented the following scenario in explanation: a fraudster sells something to a customer by misrepresenting its value (*e.g.*, the fraudster sells a cheap knock-off as a Louis Vuitton handbag).[22] The customer then uses a valid check to purchase the handbag, which the fraudster cashes. In such a case, the fraudster obtained property in the bank's control (the money in the customer's checking account) and made false representations (misrepresenting the value of the handbag).[23] However, the Court explained, this scenario does not violate Section 1344(2) because the "by means of" requirement is not met (*i.e.*, the means by which the bank parted with its property was a valid check and the fraudster's misrepresentation about the value of the handbag did not induce the bank to part with its money).[24] Therefore, federal bank fraud has not been committed.

Not all of the Justices shared this limited interpretation of the "by means of" requirement. Justice Scalia (joined by Justice Thomas) did not think it was necessary to narrow the scope of Section 1344(2). He used the Louis Vuitton example to prove his point. He argued that because the handbag fraudster obtained the property in the bank's control, the fraudster's deceit could be viewed as a "means of" obtaining bank's property. However, under the Court's analysis the deceit would not be deemed the "means" of obtaining the property "because tricking a buyer into swapping a check for a counterfeit carryall is not a 'mechanism naturally inducing a bank . . . to part with money in its control.'"[25] Justice Scalia agreed that Section 1344(2) should not expand to every fraud involving a check, but insisted that determining the proper scope of the "by means of" requirement to prevent intrusion on states' rights is best reserved for future cases.[26]

The primary takeaway of *Loughrin's* six-justice majority ruling is that the bank fraud statute has been expanded, and at least three justices would expand it even further. This decision will substantially impact future bank fraud prosecutions. By eliminating the intent to defraud a bank requirement from Section 1344(2), the holding allows prosecutors to bring more cases under that provision. Now, cases involving fake checks used to pay merchants for goods can be brought in some circuits where they could not be brought before. Additionally, the *Loughrin* holding increases federal caseloads by expanding federal jurisdiction over criminal cases. The concurrences not only support this expansion, but also suggest that further expansion may be in the works.

21 *Id*.

22 *Id*. at 2392.

23 *Id*.

24 *Id*. at 2393.

25 *Id*.

26 *Id*. at 2397.

Examining Title VII Discrimination and the Reading of "Sex"

By: John Michael Allen and Robert Kasey Wells

John Michael (Mac) is a third-year from Big Stone Gap, Virginia. He received his B.A. in Political Science from Virginia Tech in 2012. As well as serving as the CEO of the Business Law Network he serves as Executive Editor for Volume 4 of the Mississippi Sports Law Review, and as a Staff Editor for the Ole Miss Business Law Reporter. John Michael sits as the Elections Committee Chair for the Law School Student Body Government, and is a member of the law school's Negotiation Board.

Robert Kasey Wells has been practicing law in Waynesboro, Mississippi, since graduating Magna Cum Laude from the University Of Mississippi School Of Law in 2013. He earned his Master's Degree in Business Administration at the University of Central Arkansas in Conway, Arkansas, and his B.A. in Political Science at the University of Southern Mississippi in Hattiesburg, Mississippi. Before attending law school, he spent five years working as an oil and gas landman in several states all over the Southeast. He is currently a member of the Mississippi Bar and owns his own general law practice, handling both civil and criminal cases, with a focus on real estate and family law.

In 2013, the U.S. Supreme Court held that the Defense of Marriage Act's (DOMA) refusal to recognize same-sex marriage for the purpose of denying federal benefits to same-sex couples was unconstitutional.[1] Previously, DOMA, for federal law, defined "marriage" only as a legal union between a man and a woman.[2] States were left to define marriage, but a federal definition of marriage may not restrict the Constitutional rights of same sex-couples in states that have recognized the marriage of same-sex parties. *Windsor* provided some clarity regarding the marital rights of same-sex couples, but the issue of sex discrimination claims under Title VII by lesbian, bisexual, gay, and transgender employees remains unclear. However, sex stereotyping, a legal theory first recognized by the U.S. Supreme Court in *Price Waterhouse v. Hopkins*, posits an argument under which transgender plaintiffs have experienced success, and on which LGBT plaintiffs are now relying.[3]

1 U.S. v. Windsor, 133 S.Ct. 2675 (2013).

2 1 U.S.C. §7; 28 U.S.C. §1738C

3 Price Waterhouse v. Hopkins, 490 U.S. 228 (1989).

LGBT Claims Under Title VII

Usually employment discrimination suits are brought under Title VII of the Civil Rights Act of 1964.[4] Under Title VII, a plaintiff must make a prima facie case by showing that he or she qualifies as a member of a protected class; the statutorily protected classes are race, color, sex, and national origin.[5] A LGBT plaintiff's hurdle is that, regardless of the actions

4 42 U.S.C. §2000e (1964).

5 *Id.*; McDonnel Douglas v. Green, 411 U.S. 792 (1973) (stating that in order to make a prima facie case, plaintiff must show (i) that he belongs to a racial minority; (ii) that he applied and was qualified for a job for which the employer was seeking applicants; (iii) that, despite his qualifications, he was rejected and (iv) that, after his discharge the position remained open and the employer continued to seek applicants from persons of complainant's qualifications).

giving rise to the lawsuit, Title VII does not list sexual orientation or sexual identity as a protected class.[6]

Does "Sex" Include Sexual Orientation?

Under Title VII's protected classes, "sex" is the only class under which a sexual orientation plaintiff could fit. In the past, the reasoning courts initially employed in addressing the question flowed from a narrow, plain reading of the statute.[7] In early Title VII litigation, courts held that sex should be given its plain meaning, which makes it unlawful to discriminate against women because they are women and against men because they are men.[8] Further, courts have noted that sex should be given its traditional meaning absent legislative intent to the contrary.[9] The reasoning behind this narrow interpretation applied by courts relied on the biological differences between men and women, and the sparse legislative history regarding the groups of people Congress intended to be included within "sex." Court holdings were also premised on Congress's rejection of amendments to Title VII seeking to add sexual orientation as a protected class, as well Congress's failure to pass a separate law making discrimination based on sexual orientation illegal.[10]

However, in 1989, the Supreme Court questioned courts' narrow interpretation of "sex" in Title VII and ruled that an employee had been discriminated against because of her sex because she did not conform to, or exhibit, stereotypical female behavior.[11] In *Price-Waterhouse v. Hopkins*, the plaintiff, Ann Hopkins, was repeatedly denied a promotion because of her brash demeanor at her workplace.[12] Hopkins was even told by a supervisor that she would improve her chances of being promoted if she would act and dress more femininely.[13] The Supreme Court reasoned that, by denying Hopkins a promotion based on preconceived ideals, or stereotypes, of how a woman should act in the workplace, gender had been part of the employer's consideration. Concluding that the employer's decision was partly based on sex, the Court held that there had been the type of discrimination prohibited by Title VII, and that the employer could not fully escape liability.[14] The decision broadened Title VII's definition of "sex" to include gender stereotyping, but did not expand coverage to sexual orientation plaintiffs.[15]

Extending *Price Waterhouse* to Transgender Plaintiffs

Price Waterhouse did, however, establish a gender stereotyping argument that transgender plaintiffs have used. The cases made by transgender plaintiffs have been premised on the argument that one's sexual identity is included within gender stereotypes, just as the stereotype about the behavior of a woman in the workplace in *Price Waterhouse*.[16] In *Smith v. City of Salem* the plaintiff, a firefighter, had been diagnosed with a gender identity disorder. Smith began to display characteristics not associated with males, and received comments from coworkers and supervisors that he was not "masculine enough."[17] Subsequently, City of Salem officials requested that Smith submit to psychological evaluations, hoping that Smith would comply and be deemed unfit for his position, or not comply and City

6 42 U.S.C. § 2000e-2.

7 Ulane v. Eastern Airlines, 742 F.2d 1081 (7th Cir. 1984) (reading "sex" to mean no more than one's gender); Sommers v. Budget Marketing, 667 F. 2d 748 (8th Cir. 1982) (ascribing the plain meaning to "sex" absent Congressional intent to do otherwise).

8 Ulane, 742 F.2d at 1086.

9 Sommers, 667 F. 2d at 759.

10 *Id.*; Alex Reed, *Abandoning EDNA*, 51 Harv. J. on Legis. 277 (Summer 2014).

11 Price Waterhouse, 490 U.S. 228.

12 *Id.* at 235.

13 *Id.*

14 *Id.* at 257.

15 *Id.*

16 Smith v. City of Salem, 378 F.3d 566 (6th Cir. 2004).

17 *Id.*

would then have grounds for termination.[18] Smith asserted claims of sex discrimination and retaliation under Title VII.[19] The Sixth Circuit held that Smith had standing to bring his lawsuit, reasoning that his failure to conform to sex stereotypes as a transgender qualified under the "because of sex."[20] The Court paralleled City's treatment of Smith to that of Hopkins, stating that so long as "sex" is the driving force behind an adverse employment action, then a plaintiff has standing under Title VII.

Plaintiffs have argued that there are preconceived notions as to a person's sexual identity based on his or her gender, and a person's sexual identity should fall in line with those stereotypes. When actual sexual identity does not meet the expectation, gender stereotyping has occurred, just as in *Smith*.[21] Therefore, if an employee has suffered an adverse employment action based on a gender stereotype about his or her sexual identity, then sex has been a consideration of the employer, as prohibited under Title VII. "Sex" has been held to include transgender plaintiffs in the Sixth, Ninth, and First Circuits.[22] The Eleventh Circuit adopted a *per se* approach for transgender Title VII plaintiffs, finding that the term "sex" includes transgender plaintiffs under Title VII. The underlying rationale of the *per se* approach is no different from the gender stereotyping approach, the Eleventh Circuit has simply decided that the nature of transgenderism carries enough of a "congruence with sex" that it is actionable.[23] This stance has been adopted by the EEOC, to which the courts often look for guidance in interpreting definitions and applying statutes.[24]

Plaintiff's asserting a Title VII claim based on sexual orientation are now using the *Price Waterhouse* framework. Just as courts initially refused to include transgender in Title VII's definition of "sex," courts have also initially declined to include sexual orientation in the definition of "sex."[25] However, more and more, claims of workplace discrimination because of sexual orientation are using the gender stereotyping theory to argue that the plaintiffs qualify under "sex," and the cases receiving mixed results.

Most recent is *Terveer v. Billington*.[26] A former employee, Terveer, brought action against the Librarian for the Library of Congress, alleging a hostile work environment leading to a constructive discharge because of his sexual orientation. After learning that the plaintiff was gay, his supervisor repeatedly lectured him, telling him he would go to hell.[27] The supervisor assigned the plaintiff a heavy workload, usually split between six employees, began giving the plaintiff poor reviews, and continued to lecture the plaintiff on his lifestyle, focusing on his sexual orientation.[28] After the plaintiff complained to upper management, the supervisor informed the plaintiff that he would be subjected to a heightened level of scrutiny in his work reviews.[29] The continued harassment and intimidation eventually led to medical problems and a leave of absence for the plaintiff. Subsequently, the plaintiff was terminated. Terveer argues that the hostile work environment was caused by his supervisor's harassment, brought on by a preconceived notion, or stereotype, about

18 *Id* at 572.

19 *Id*.

20 *Id*.

21 *Id*.

22 Schwek v. Hartford, 204 F.3d 1187, 1201-02 (9th Cir. 2000); Kastl v. Maricopa County Comm. College. Dist., 325 Fed. Appx. 492 (9th Cir. 2009); Smith v. City of Salem, OH, 378 F.3d 566 (6th Cir. 2004); Myers v. Cuyahoga County, OH 182 Fed.Appx. 510, 519 (6th Cir. 2006); Rosa v. Park West Bank & Trust Co., 214 F.3d 213 (1st Cir. 2000).

23 Glenn v. Brumby, 663 F.3d 1312 (11th Cir. 2011).

24 Meritor Savings Bank v. Vinson, 477 U.S. 57, 65 (1986).

25 Swift, 770 F.Supp.2d 483; *see* Dawson v. Bumble & Bumble, 398 F.3d 211 (2nd Cir. 2005).

26 Terveer v. Billington, 34 F.Supp.3d 100 (2014).

27 Terveer, 2014 1280301, at *2.

28 *Id*.

29 *Id*.

the appropriate sexual orientation of men. This stereotype, Terveer contends, is the kind of sex stereotyping prohibited by *Price Waterhouse*.[30] Therefore, Terveer's hostile work environment and the adverse employment action arose because of his sex. In a motion for summary judgment, the defendant argued that, on the sex discrimination claim, the complaint fell short of alleging facts that showed the supervisor's conduct was motivated by the plaintiff's behavior, demeanor, appearance, or lack of conformity with the stereotypical male.[31] In agreeing with the plaintiff's argument, the United States District Court for the District of Columbia denied the defendant's motion for summary judgment on the sex discrimination issue. The Court reasoned that Terveer had met the burden of pleading by alleging that as a homosexual male, his sexual orientation was not consistent with his employer's perception of acceptable gender roles, he did not conform to his employer's gender stereotypes, and that this had removed him from his supervisor's preconceived definition of male.[32] The Court's acknowledgment that a stereotype about an employee's gender qualified as "sex" under Title VII allowed Terveer to continue his claim for sex discrimination.

Under the analysis from Teerver, an employee could qualify as a member of a protected class under Title VII on the basis of sexual orientation alone, regardless of the characteristics the employee displays. This ruling makes Terveer distinguishable from other cases where plaintiffs were not allowed to proceed by applying the gender stereotyping theory to sexual orientation alone, but were otherwise allowed to proceed because the plaintiff did not exhibit stereotypical behavior and characteristics associated with his or her gender.

The Future of "Sex" and Sexual Orientation

The gender stereotyping theory being used in claims brought by homosexual and bisexual plaintiffs parallels that of the cases brought by transgender plaintiffs under Title VII, and is often difficult to distinguish. The line of reasoning in Terveer could be the prevailing analysis. The meaning of "sex" in Title VII might become expanded in more jurisdictions and allow plaintiffs to proceed under the sex stereotyping theory because of sexual orientation, regardless of his or her behavior, exhibited traits or characteristics. It follows that, as social awareness surrounding LGBT issues continues to sharpen, this could be a wave of new litigation to watch out for in the future.

30 Price Waterhouse, 490 U.S. at 256.
31 Terveer, 2014 WL 1280301, at *9.
32 *Id.*; Rouse v. Berry, 680 F.supp.2d 233, 236; Jones v. Bernanke 686 F.Supp.2d 31, 40.

A Win For Bank Officers and Directors

By: Aaron Spearman and Pat Caldwell

Aaron Spearman is a third year law student from Tupelo, MS. He is an Executive Editor of the Business Law Reporter. Aaron received his B.B.A .in International Business and B.A. in Spanish from Mississippi State University, where he was a member of Beta Gamma Sigma Business Honor Society and Phi Kappa Phi. This past summer, he served as an extern in the Office of the Mississippi State Treasurer Lynn Fitch. After graduation, he plans to practice in Mississippi.

Pat Caldwell is a Partner at Riley Caldwell, Cork & Alvis, P.A in Tupelo, MS. The firm served as general counsel to the second-largest publicly-traded bank holding company in Mississippi for over thirty years and to its subsidiary bank for over fifty years. Mr. Caldwell earned his Bachelor of Public Administration from the University of Mississippi in 1978, and his JD from the University of Mississippi School of Law in 1981. While at Ole Miss, he was a part of Phi Kappa Phi Legal Fraternity and Omicron Delta Kappa. Mr. Caldwell was also the University of Mississippi Judicial Council Chairman and a Taylor Medalist. Selected as a Mid-South Super Lawyer, he is a member of the Lee County Bar Association and the Mississippi Bar Association. He is also a member of the American Bankers Association (General Counsels Group and past Chairman). Mr. Caldwell formerly served as Tupelo City attorney and MDOT Special Counsel.

The FDIC has lost its first case against bank directors and officers of failed banks that relates to the financial crisis of 2007-2009.[1] In *FDIC v. Willetts,*[2] a court rejected claims by the FDIC related to whether bank officers and directors satisfied the applicable standard of care in the approval of loans tied to the financial crisis. The court granted the defendants' motion for summary judgment on the FDIC's claims of negligence, gross negligence, and breach of fiduciary duty, finding that North Carolina's Business Judgment Rule precludes the court from questioning decisions that were made in good faith and for a rational business purpose.

The FDIC filed the lawsuit to recover its loss subsequent to the bank's failure. When Cooperative Bank ("Cooperative") became insolvent in 2009, the FDIC was appointed as receiver of the bank.[3] The FDIC sold Cooperative's assets to another institution with an obligation that the FDIC assume 80% of the purchasers' losses on the bank's assets.[4] The FDIC sought recovery from Cooperative's directors and officers for its loss of $40 million.[5]

The FDIC alleged that Cooperative made loans without regard to prudent lending practices or previous criticisms from state and federal examiners.[6] Further, it alleged that officers ignored

1 Floyd Norris, *Failed Bank's Broken Vows Mean Little*, September 18, 2014, http://www.nytimes.com/2014/09/19/business/in-ruling-that-favors-failed-bank-promises-meant-little.html?_r=0.

2 No. 7:11-cv-00165-BO, 2014 WL 4828330 (E.D. N.C. Sept. 11, 2014).

3 *Willetts*, at 1.

4 *Id.*

5 *Id.*

6 *Willetts*, at 1. The FDIC alleged that Cooperative ignored "practices established by [its] loan policy, published regulatory guidelines, and generally established banking practices, such as obtaining and verifying current financial informa-

the bank's own lending rules and that the directors did nothing to ensure the officers' compliance with the rules.[7] The defendants sought summary judgment on grounds that they acted reasonably and in good faith.

The District Court for the Eastern District of North Carolina, applying North Carolina's version of the business judgment rule, granted the defendants' motion on all claims.[8] The business judgment rule is designed to protect against the review of business decisions made by those elected or authorized to represent a corporation.[9] The court explained, "[a]bsent 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 have 'availed themselves of all material and reasonably available information' and honestly believed they were acting in the best interest of the corporation."[10]

The court noted that two presumptions are made by the application of the business judgment rule.[11] The first presumption establishes that directors and officers "acted with the honest belief that their action was in the best interest of the corporation."[12] The second presumption provides that a court cannot overturn a decision by an informed, loyal board "unless it cannot be attributed to any rational business purpose."[13]

The judge determined that nothing in the discovery produced suggested bad faith in the approval of the challenged loans.[14] Because many documents were sealed,[15] including the FDIC's arguments against summary judgment, it is difficult to determine what facts suggest that there was no bad faith.[16] However, as a matter of law, the Court found the discovery lacking.

While the FDIC advanced this case as receiver for the failed institution, the FDIC had also been Cooperative's primary regulator. The judge took issue with the FDIC giving Cooperative a satisfactory safety and soundness examination grade and later suing the directors and officers for the flaws of the loan process. The FDIC alleged that Cooperative ignored warnings about the bank's underwriting and credit practices given in Reports of Examination ("ROE"). Although the FDIC did recommend changes in the ROEs, it also gave a CAMELS "2" rating to the bank, signifying a satisfactory management rating. [17] "[T]o now argue that the process behind the loans is irrational is absurd," the judge explained.[18] The court also reasoned that Cooperative rationally pursued the questioned

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tion, adhering to minimum loan-to-value ("LTV") ratios and adhering to maximum debt-to-income ("DTI") ratios."

7 *Id*.

8 *Id.* at 6.

9 *Id.* at 3. "The business judgment rule is akin to a gross negligence standard." See *First Union Corp. v. SunTrust Banks, Inc*., 2001 N.C.B.C. 09, 2001 WL I885686 *IO (N.C. Super. August IO, 200I).

10 *Willetts*, at 3, (quoting *State v. Custard*, 2010 N.C.B.C. 6, 2010 WL 1035809 *21 (N.C. Super. March 19, 2010) (quoting *In re Citigroup Inc. S'holder Derivative Litig*., 964 A.2d 106, 124 (D.Ch. 2009))).

11 The application of the rule to bank officials is part of an expansive view of the rule. Other courts have found that banks are held to a higher standard. See: *FDIC v. Loudermilk,* 761 S.E.2d 332 (GA 2010).

12 *Willetts,* at 4.

13 *Id*.

14 *Id*.

15 It should be noted that many documents were sealed without a request from counsel of either side. Norris, *supra* note 2.

16 *Id*.

17 *Willetts*, at 7. "CAMELS" is an acronym for six primary areas of bank operations that are evaluated by bank examiners: *C* apital, *A* sset Quality, *M* anagement, *E* arnings, *L* iquidity, and *S* ensitivity to Market Risk. A score of "1" or "2"(on the scale of 1-5) signifies that there are no material supervisory concerns.

18 *Id*. at 5.

loans with the goal of growing the institution in a highly competitive market.[19]

The court disagreed with the FDIC's argument that Cooperative foresaw the financial crisis.[20] Economic forecasts in 2006 projected a strong economy.[21] The court noted that Federal Reserve Chairman Ben Bernanke once acknowledged that regulators could not have anticipated the economic downturn.[22] The court stated that the FDIC's assertion that Cooperative disregarded its own foresight of an economic downturn was "wholly implausible."[23]

The court also addressed the idea of selective prosecution. The judge remarked, "It appears that the only factor between defendants being sued for millions of dollars and receiving millions of dollars in assistance from the government is that Cooperative was not considered to be 'too big to fail.'"[24] The judge perceived the different treatment of smaller financial institutions to be "unfortunate if not outright unjust."[25] The "too big to fail" argument made by the judge veers away from the examination of whether these directors and officers satisfied the required standard of care. The FDIC may have brought this apparently unrelated finding on itself by arguing that Cooperative should have foreseen the crisis.

The court's arguments might not fare well on appeal.[26] The appellate court will examine whether a jury could find based on the facts that the officers and directors are liable. The judge's statements in the order about the different treatment of smaller financial institutions will matter little. The appellate court will most likely be very reluctant to hold the FDIC's inspection against it. To preclude liability when there is any sort of positive regulatory rating would have a negative effect on future inspections. The court will likely find the matter of selective prosecution to be irrelevant because it does not relate to whether the defendants are liable.

It is likely that the FDIC will argue on appeal that the court did not properly apply the business judgment rule. The North Carolina case on which the court relied, *State v. Custard* [27], noted that the review of director and officer conduct is context specific.[28] Relying on *In re Caremark International Inc. Derviative Litigation*[29], the prevailing standard in litigation related to directors' breach of fiduciary duty, *Custard* held that a plaintiff "must 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."[30] The FDIC may contend that the warnings in the ROEs were the clear signal that Cooperative ignored.

If the ruling is upheld, it would provide a line of defense that will surely be mimicked by other directors and officers. In the previous 97 cases filed by the FDIC against the directors and officers of failed banks, all but one were settled.[31] The lone exception was a victory for the FDIC.[32] If *Willetts* ultimately changes the FDIC's pattern of success, the FDIC can expect to encounter this defense in similar lawsuits.

A reduced fear of personal liability may lessen the task of banks attracting and retaining qualified directors. Having dedicated directors

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19 *Id.*

20 *Id*. at 6. The FDIC did not merely argue that Cooperative should have foreseen the financial crisis, but that it actually foresaw the Great Recession.

21 *Id*.

22 *Id*. at 7.

23 *Id*.

24 *Id.*

25 *Id.*

26 The FDIC filed a Notice of Appeal on October 2, 2014.

27 2010 N.C.B.C. 6, 2010 WL 1035809 (N.C. Super. March 19, 2010).

28 *Id*. at 22.

29 698 A.2d 959 (Del.Ch. 1996).

30 *Custard,* at 22.

31 Norris, *supra* note 2.

32 *Id*.

is critical to a financial institution's success, especially for community banks that need local participation in the communities they serve. A related concern is whether directors should have any involvement in the approval of loans. Many institutions have stopped or will stop the practice of director loan approval, or set high dollar limits for director approval. If directors do participate, they must be clear as to the amount of diligence that should be performed.

The court rejected claims by the FDIC that alleged the directors and officers of Cooperative acted in bad faith when approving many risky loans that led to the bank's insolvency. The court applied the business judgment rule and found that the FDIC did not overcome the presumptions of the rule. This case may be used as a framework by attorneys defending other institutions against similar claims made by the FDIC.

ANNOUNCEMENTS

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The Business Law Network at The University of Mississippi School of Law invites you to attend our Second Annual Business Law Conference in Jackson, Mississippi on April 3rd, 2015 at the Fairview Inn. Our event is headlined by Keynote Speaker, Secretary of State of Mississippi, Delbert Hosemann. For a cost of only $50.00, we are offering CLE credit, and featuring four panels of practitioners, professors, and students speaking on legal issues in tax, banking, and bankruptcy. Lunch is provided for all attendees!

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