

# LEWIS RICE *Bank Law Update*

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## A Reminder to File UCC-1s Properly

### A recent opinion from a bankruptcy appellate panel

illustrates the importance under Revised Article 9 of the UCC of precisely identifying the debtor in a financing statement. In *Hastings State Bank v. Stalemaker* (B.A.P. 8th Cir. 2010), the court held that, under UCC 9-503(a)(i), if the debtor is a “registered organization” under state law (such as a corporation or LLC), then the portion of the financing statement requiring the debtor’s exact full legal name must contain only the name of the debtor as indicated on the public record of the debtor’s jurisdiction of organization. According to the court, the inclusion of any superfluous information in the debtor’s name, such as a “doing business as” or “d/b/a” designation, may render the financing statement seriously misleading and thereby prevent the filing from properly perfecting the lender’s security interest.

In *Hastings State Bank*, the lender-filed financing statement identified the debtor as “EDM CORPORATION DBA EDM EQUIPMENT” (the debtor’s legal name, EDM Corporation, and a trade name under which it regularly conducted business, EDM Equipment). Two subsequent UCC searches performed by lenders using the debtor’s legal name failed to reveal the lender’s prior financing statement. In the subsequent lien priority dispute, the court affirmed that the lender financing statement did not properly name the debtor due to the inclusion of the

## Potential FDIC Liability for Bank Officers and Directors

**As this article went to press, 365 banks had been shuttered** by regulatory authorities since January 1, 2008 (for reference, only 27 banks failed from 2000 to 2007). In several instances, the FDIC has pursued claims against individuals, including directors and officers, for damages from these recent failures in the banking industry. When the FDIC conducts an investigation of a failed bank, whether claims are brought against directors and officers for damages, and which directors and officers are held accountable, is highly dependent on the particular facts and circumstances that led to the failure. In order to pursue a claim, the FDIC must determine if it is more likely than not to succeed in any litigation and if the potential recovery, given the insurance coverage and personal assets of potential defendants, warrants the cost of litigation. While nothing can guarantee that a particular director or officer will not be targeted, there are actions individuals can take to help their cause in the event of an FDIC investigation. To understand why these actions can be effective, we will first discuss the current FDIC cases against bank officers and directors.

The first D&O liability suit following the recent bank failures was filed in July 2010 with claims brought against directors and officers in the Central District of California for the failing of IndyMac Bank. Since then, six other suits have been filed arising out of the failings of Heritage Community Bank, Integrity Bank of Alpharetta, GA, 1st Centennial Bank, Corn Belt Bank and Trust Company, Washington Mutual Bank, and Wheatland Bank. According to the FDIC’s website, suits against hundreds of additional directors, officers, fidelity bondsmen, attorneys, and appraisers have been authorized but not yet filed, seeking damage claims topping \$3.86 billion. Thus far, the cases filed by the FDIC generally allege the pursuit of a lending strategy in higher risk markets that were only viable with increasing or stable real estate prices, leading to bank failures when the real estate bubble burst. Most cases involve the addition of a higher risk lending department or the shifting of lending practices in an established bank that was seeking new or increased revenue streams. Two cases involve banks that were founded on a high-risk, high-growth strategy. Only one case is not directly tied to the burst of the real estate bubble.

In the case filed against former officers of Washington Mutual Bank (*FDIC v. Killinger*, filed March 16, 2011 in the Western District of Washington), the defendants are the officers who allegedly initiated and implemented a higher risk lending strategy in an otherwise established, stable lending environment. The department allegedly shifted its mortgage lending program to a “narrow and focused” geographic concentration where double-digit growth could be realized by emphasizing higher-risk option ARMs, subprime loans, home equity lines of credit, and loans with effective loan to value ratios of 100%. The officers allegedly ignored continued warnings from risk managers about loan quality and aggressiveness of the sales force and were heard deriding risk managers as “checkers checking checkers.” The bank also allegedly failed to maintain adequate technology to monitor and evaluate the risks in its portfolio, further undercutting the work of risk managers. In the midst of these high-risk strategies and poor risk management, incentive compensation was allegedly paid to loan officers, underwriters, and executives for the volumes of loans originated.

When the real estate market turned, the high-risk loans led to extraordinary losses which, in turn, led to the largest bank failure in U.S. history. The FDIC claims against the officers include FIRREA

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gross negligence claims, state law negligence and breach of fiduciary duty claims, and claims against two of the officers and their spouses for fraudulent conveyance of assets.

In the case against former directors and officers of Integrity Bank of Alpharetta, GA (*FDIC v. Skow*, filed Jan. 14, 2011 in the Northern District of Georgia), the FDIC alleged that from the time the bank was founded in 2000, it pursued a high-risk, high-growth strategy focused on acquisition, development, and construction loans to developers in Georgia and Florida. The bank's lending policy allegedly contained a higher lending limit than was allowed by state law, and was still exceeded on numerous occasions. Incentive compensation was allegedly paid based on the volume of loans originated and renewed with no consideration for loan performance. To push loans through, loan officers were even alleged to have controlled the appraisal process. In order to mask liquidity and delinquency problems, the bank allegedly regularly financed interest reserves. To avoid the appearance of exceeding lending limits, the bank allegedly participated in the creation of single-purpose entities to fund loans with two substantial borrowers. Bank officers are alleged to have ignored warnings of state and federal regulators each year from 2003 through 2007.

The allegations point to intentional, aggressive, rule-bending (and breaking) behavior by the executives to pursue the bank's high-risk, high-growth strategy. The FDIC claims against the officers and directors include FIRREA gross negligence claims and state law negligence and breach of fiduciary duty claims. Two of the bad loans that led to the failure of Integrity Bank have also served as the basis for two additional professional liability lawsuits filed against two law firms and a title company.

As these brief summaries of cases suggest, active involvement in high-risk lending strategies can lead to personal liability under a D&O suit by the FDIC. In addition to avoiding obvious personal liability triggers such as misappropriating bank assets or bank opportunities for personal benefit, commingling personal assets with bank assets, and failing to disclose conflicts of interest, directors and officers must guard against personal liability from lack of ordinary care in business practices such as originating poor quality loans, failing to obtain and maintain adequate loan documentation, and pursuing high-risk lending strategies without requisite risk management. Actions by directors and officers that may help prevent an individual from being targeted by a suit include speaking out against and voting against actions that jeopardize the bank's viability, actively engaging in efforts toward compliance and safe and sound operations, and cooperating with the FDIC in its post-failure investigation.

For directors and officers who may be facing FDIC investigations, it is important to take steps with counsel to prepare for potential litigation. Directors and officers can educate themselves on the general litigation risks involved in the industry. It may also be valuable to become informed on the particular risks of the bank's practices by reviewing examination reports, third party reports, and other documents related to the bank's operations and compliance. Finally, directors and officers should review, preferably with counsel, the bank's D&O insurance policies to understand responsibilities with respect to the insurer, to determine the bank's coverage for directors and officers, and to confirm that FDIC actions have not been excluded from the policy.

A summary of the FDIC's professional liability lawsuits can be found online at:

<http://www.fdic.gov/bank/individual/failed/pls/index.html>.

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## Small Business Lending Fund Update

**In the Fall 2010 edition** of the *Lewis Rice Bank Law Update*, we provided an overview of the Small Business Lending Fund Program, created as part of the Small Business Jobs Act of 2010 enacted in September 2010. The program was designed to stimulate small business growth by creating the \$30 billion Small Business Lending Fund ("SBLF") administered by the U.S. Treasury Department. Through the SBLF, eligible institutions can access capital for making small business loans by issuing preferred stock or comparable securities to the Treasury. Participating banks also benefit from reduced dividend rates on their securities if they are able to increase overall lending to small businesses.

### Term Sheet for S Corporations and Mutuals Released

On May 12, 2011, the Treasury finally released term sheets for Subchapter S corporations and mutual institutions (the C Corporation term sheet was released in December). While the terms are generally very similar to those for C Corporations, there are notable differences. The investment vehicle for Subchapter S corporations and for mutual institutions without a mid-tier stock holding company is unsecured subordinated debentures which qualify only for Tier 2 capital treatment (SBLF senior preferred stock for participating C Corporations and for mutual institutions with a mid-tier stock holding company receive Tier 1 treatment). The Treasury has also revised the applicable dividend rates to reflect the different tax treatment of Subchapter S corporations and mutual institutions without a mid-tier holding company.

*The deadline for Subchapter S corporations and mutual institutions to file an application is June 6, 2011. Any such institution interested in participating is encouraged to apply for funds because submitting an application does not obligate the institution to participate.*

### General Terms and Guidance

Term sheets for new investments, a separate term sheet for TARP refinancing, a comprehensive guide for community banks, an application form and instructions, and a guide for creating the small business lending plan required under the application are all available on the Treasury's dedicated SBLF website at [www.treasury.gov/SBLF](http://www.treasury.gov/SBLF). An interagency publication, "Underwriting Standards for Small Business Loans Originated Under the Small Business Lending Fund Program," is available on the FDIC's website at: <http://fdic.gov/news/news/financial/2010/fil10090a.html>.

Qualified small business lending includes any loan or group of loans with an original principal or commitment amount of \$10 million or less or that is made to a borrower which had \$50 million or less in revenues during the last complete fiscal year. Qualified loans must be of the following types:

- commercial and industrial loans;
- owner-occupied nonfarm, nonresidential real estate loans;
- loans to finance agricultural production and other loans to farmers; and
- loans secured by farmland.

The Treasury specifically excluded from qualified small business lending the portion of any loans guaranteed by the U.S. Small Business Administration or any other U.S. government agency or sponsored enterprise and any portion of loans held by the issuer for which the risk is assumed by a third party (such as participated loans). Thus, SBA 7(a) loans, among others, will not qualify for calculating the issuer's small business lending.

Some commentators have suggested that this exclusion will inhibit the effectiveness of the SBLF program because SBA lenders are among the best equipped to address the needs of small businesses. According to the Treasury, the policy is to prohibit institutions' "double dipping" by taking advantage of more than one government program at once. There has also been criticism of the exclusion of non-owner occupied commercial real estate loans from the definition of small business lending. This exclusion, unlike the government guaranteed loan exclusion, was not imposed by the Treasury but, rather, was mandated by Congress in the Jobs Act.

### SBLF and Congress

Senator Olympia Snowe (R – ME) introduced a bill that would place further limits on banks' access to SBLF capital. Among other things, the bill (S. 681.IS) would exclude any bank that participated in TARP from applying for SBLF funds and bar the use of SBLF funds as Tier 1 capital, even for C Corporations. Many commentators believe that the bill has little chance of passing as a standalone measure, but may have a better chance if it is attached to a less controversial bill as an amendment.

Others in Congress, such as Senators Ben Cardin (D – MD) and Mary Landrieu (D – LA), have questioned the Treasury for taking too long to distribute SBLF funds to its over 700 applicants. The Treasury does not expect to begin releasing funds until June.

We will continue to monitor these developments in the SBLF program. As always, you can contact any of our banking lawyers with specific questions and concerns.

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"DBA" designation, and was materially misleading due to the failure of the searches to reveal the financing statement. The court therefore held that the lender failed to properly perfect its security interest.

The court's holding in *Hastings State Bank* emphasized the importance of the jurisdiction's standard search logic. The jurisdiction's standard search logic only revealed the names of debtors that exactly matched the name searched. As a result, the inclusion of additional information, other than "noise words" (e.g., "company," "limited," "incorporated," etc.) filtered out by the search logic, prevented subsequent searches under the debtor's organizational name from revealing prior liens. The court thus held that a financing statement is materially misleading if it is not revealed by a search using the debtor's legal name and the jurisdiction's standard search logic. This holding is consistent with UCC 9-506(c), which provides that a financing statement that fails to comply with the requirements of UCC 9-503 is not "seriously misleading" if a third party searching the records of the filing office under the debtor's full legal name and using the filing office's standard search logic would find the financing statement.

Lenders must understand each applicable jurisdiction's standard search logic for purposes of properly filing financing statements. While each jurisdiction's rules may differ, many states have adopted a form of the standard search logic contained in the UCC, Article 9 Model Administrative Rules. The search logic contained in these rules will only reveal the names of debtors that exactly match the name being

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searched, with possible modifications to filter out certain “noise words” designated by the jurisdiction. A financing statement containing superfluous information in the debtor’s name may not be revealed when a subsequent search is performed using the debtor’s correct legal name. This could render the financing statement materially misleading and preclude a lender from perfecting its security interest.

In order to properly identify an organizational debtor—including a corporation, limited partnership, or limited liability company—the lender must exclusively list the debtor’s exact full legal name as it appears in its organizational documents. Alternative names, while not necessary, may be included on the financing statement as additional debtors. Lenders using Form UCC-1 need only follow the Form’s instructions, which instructs lenders not to use the debtor’s trade name, “DBA,” “AKA,” “FKA,” or division name, in place of or combined with the debtor’s full legal name.

There are several steps lenders can take to ensure compliance with Revised Article 9 when filing UCC-1s against “registered organizations.” First, the lender should ascertain the debtor’s full legal name from the organizational or charter documents filed in the debtor’s jurisdiction of organization. In Missouri, for example, this would be accomplished by ordering certified articles of incorporation (for corporations) or articles of organization (for limited liability companies) from the Missouri Secretary of State. Second, the lender should only list as the debtor’s full legal name the debtor’s name exactly as it appears on its filed organizational documents. Finally, after filing the financing statement, the lender should run a search using the debtor’s full legal name to ensure that the search (which will use the jurisdiction’s standard search logic) reveals the financing statement, and thus the lender’s security interest is properly perfected.

Revised Article 9’s rules regarding financing statements involving debtors that are not “registered organizations,” including individuals, trusts, trustees, sole proprietorships, and partnerships, are complex and, in some respects, rather ambiguous. Accordingly, these rules should be reviewed carefully to ensure financing statements against these types of debtors are properly completed to ensure perfection.

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