

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]

Michael A.F. Johnson
Nancy L. Perkins
Elliott C. Mogul
Joanna G. Persio
ARNOLD & PORTER LLP
555 Twelfth Street, NW
Washington, DC 20004
(202) 942-5000
Michael.Johnson@aporter.com
Counsel for Amici Curiae

Additional Amici Curiae

Alabama Bankers Association, Alaska Bankers Association, Arizona Bankers Association, Arkansas Bankers Association, California Bankers Association, Colorado Bankers Association, Connecticut Bankers Association, Delaware Bankers Association, Florida Bankers Association, Georgia Bankers Association, Hawaii Bankers Association, Heartland Community Bankers Association, Idaho Bankers Association, Illinois Bankers Association, Illinois League of Financial Institutions, Indiana Bankers Association, Iowa Bankers Association, Kansas Bankers Association, Kentucky Bankers Association, Louisiana Bankers Association, Maine Bankers Association, Maryland Bankers Association, Massachusetts Bankers Association, Michigan Bankers Association, Minnesota Bankers Association, Mississippi Bankers Association, Missouri Bankers Association, Montana Bankers Association, Nebraska Bankers Association, Nevada Bankers Association, New Hampshire Bankers Association, New Jersey Bankers Association, New Mexico Bankers Association, New York Bankers Association, North Carolina Bankers Association, North Dakota Bankers Association, Ohio Bankers League, Oklahoma Bankers Association, Oregon Bankers Association, Pennsylvania Bankers Association, Puerto Rico Bankers Association, Rhode Island Bankers Association, South Carolina Bankers Association, South Dakota Bankers Association, Tennessee Bankers Association, Texas Bankers Association, Utah Bankers Association, Vermont Bankers Association, Virginia Bankers Association, Washington Bankers Association, West Virginia Bankers Association, Wisconsin Bankers Association, and Wyoming Bankers Association.

TABLE OF CONTENTS

	<u>Page</u>
STATEMENT OF <i>AMICI CURIAE</i>	1
INTRODUCTION	2
ARGUMENT	3
I. THE STANDARD FDIC PROPOSES WOULD INHIBIT USEFUL AND EFFICIENT BUSINESS ACTIVITY	3
A. The Business Judgment Rule Furthers Important, and Widely Recognized, Social and Economic Benefits.....	3
B. An Ordinary Negligence Standard Would Discourage Qualified Potential Directors and Officers from Serving.....	6
C. An Ordinary Negligence Standard Would General Unwarranted Litigation and Related Bank Expense.	10
D. An Ordinary Negligence Rule Would Make Providing Credit More Costly.....	11
E. An Ordinary Negligence Standard Would Constrain Innovation and Distribution of Credit.	13
II. FDIC’S PROPOSED ORDINARY NEGLIGENCE STANDARD CONTRAVENES GOVERNING LAW.....	14
A. FDIC Relies Upon Authorities That North Carolina Courts Would Not Apply in Defining North Carolina’s Business Judgment Rule.....	15
B. Applicable Authority Contravenes FDIC’s Position.....	16
1. North Carolina Courts Have Long Recognized the Value of the Business Judgment Rule.	16

2.	North Carolina Case Law Confirms that the Rule Requires More Than Simple Negligence for Directors and Officers to Become Liable.	18
3.	The North Carolina Legislature Preserved the Common Law Business Judgment Rule.	25
III.	NO COUNTERVAILING POLICY REASONS SUPPORT FDIC’S PROPOSED ORDINARY NEGLIGENCE STANDARD.....	27
	CONCLUSION.....	30

TABLE OF AUTHORITIES

Page(s)

[TO BE ADDED]

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 in North Carolina and across the nation. 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

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; and 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.]

members (which include state and federally chartered banks, as well as savings and loan associations) at the state and local level.

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 innovation 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 outcome would negate decades of established case law, undermine the sound policy rationale supporting the rule, and diminish the economic and social benefits the rule provides.

FDIC’s position, if adopted, would advance only its own narrow economic interests. By definition, a receiver 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 the innovative 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.

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

In North Carolina, as in many other jurisdictions, the business judgment rule serves as a cornerstone corporate legal principle that embodies 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, 48 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

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.

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, which encourages “innovation and venturesome business activity.” *Alford*, 349 S.E.2d at 48 n.5. The rule is necessary to achieve that result because, as one treatise “bluntly” explains, “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* (2d. ed. 2007) at 243. 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 predictably discourage officers and directors from undertaking valuable but risky projects.” *Id.*

A widely cited decision of the Delaware Chancery court, to which the 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, 1052-53 (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"). Put more directly, "[i]f 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.*, 2001 WL 1885686, at *4.

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).” Posner, *Economic Analysis of Law* (Ninth ed. 2014) at 547 (emphasis in original).

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. *See, e.g., Custard*, 2010 WL 1035809 at *15 (“The corporate structure requires competent directors willing to serve.”). Indeed, FDIC has expressly 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 the FDIC recognizes that this is particularly critical during times of economic stress, such as the 2008 economic crisis that gave rise to the events at issue here: “When an institution becomes troubled, it is especially important that it have the benefit of the advice and direction of people whose experience and talents enable them to exercise sound and prudent judgment.” *Id.*

³ Available at <https://www.fdic.gov/regulations/laws/rules/5000-3300.html>.

The approach advocated by the FDIC here, however, would effectively preclude such benefits. It would push qualified candidates away from service and hamstring the decisions of those who would be willing to serve. As North Carolina courts have repeatedly recognized, “to 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. *Custard I*, 2007 WL 2570241 at *11. 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. Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. Ct. 1996). Without it, “persons of reason, intellect, and integrity would not serve.” Samuel Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93, 97 (1979).

That is because, in many instances, directors and officers “have no incentive to justify assuming increased liability.” Diane L. Saltoun, *Fortifying the Directorial Stronghold: Delaware Limits Director Liability*, 29 B.C. L. Rev. 481, 481 n. 6 (1988); *see also First Union Corp.*, 2001 WL 1885686 at *4 (given the “substantial time commitments and legal exposure, potential directors must carefully weigh the decision to serve”). For these individuals, “[l]iability for an imprudent decision could be in the millions, but [they] rarely receive annual fees commensurate with liability risk of that

magnitude.” William Allen, Jack Jacobs, Leo Strine, *Realigning the Standard of Review of Director Due Care*, 96 Nw. U. L. Rev. 449, 455 (2002). Asking them to take on liability for good-faith business decisions under an ordinary negligence standard could, as one court put it, therefore “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’ conclusion that the scope of potential personal liability influences qualified individuals’ willingness to serve as corporate directors and officers. For example, in response to a recent survey by the ABA of its member banks, of the 668 respondents, 20% reported that a director or officer at their institution had resigned due (at least in part) to concerns about personal liability, and 40% reported that at least one qualified candidate had declined to seek or assume a director or officer position because of such concerns. [*ABA survey results*]. 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 ___. Likewise, an earlier survey by the American Association of Bank Directors (“AABD”) yielded similar results: nearly 25% of the responding banks reported that at least one individual had resigned from a director or officer role in the past five years due to fear of

personal liability.⁴ 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.

The fear of personal liability in this context is understandable not only because of the monetary stakes involved, but also because of the inherent likelihood that even well-founded decisions may appear lacking when examined after-the-fact. Indeed, “after-the-fact litigation is a most imperfect device to evaluate corporate business decisions.” *Joy v. North*, 682 F.2d 880, 885-86 (2d. Cir. 1982); *Alford*, 318 N.C. at 300 (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 bad 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.*

⁴ 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/>.

C. An Ordinary Negligence Standard Would General Unwarranted Litigation and Related Bank Expense.

The business judgment rule not only protects against judicial outcomes that reflect an inherent lack of insight, but also against the unwarranted drain on judicial and societal resources entailed in reaching those outcomes. Displacing the protection of the business judgment rule with FDIC’s proposed ordinary negligence standard would expose banks to a multitude of suits that do no more than question in hindsight the wisdom of legitimate decisions made with less-than-perfect information. Such suits would have no valuable corporate or societal purpose, and the costs they would impose would ultimately be reflected in higher costs of credit, to the detriment of the consumer. *See Alford*, 318 N.C. at 306 (“a favorable business climate” is “fostered in part by ... providing a measure of protection against ... nuisance suits”).

Ordinary negligence claims are relatively easy to plead. They are also 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.*; *Nicholson*, 488 S.E.2d at 244.

By recent estimates, the cost associated with defending a single claim for director or officer misconduct is nearly \$700,000 for a private company,

and likely more for a larger, public company.⁵ This is in addition to the substantial expenditure of employee time often necessary for litigation.⁶ Given the exceedingly high cost of discovery proceedings--to say nothing of the cost of trials--banks may be under extreme pressure to settle even baseless claims. Thus, a ruling here in favor of FDIC's proposed ordinary negligence standard could trigger a plethora of frivolous nuisance suits in North Carolina, which, even if ultimately not successful on the merits, would waste social resources with no redeeming benefit. *See* Alford, 318 N.C. at 306.

D. An Ordinary Negligence Rule Would Make Providing Credit More Costly.

Apart from the resources required directly to litigate an expanded volume of potential suits, erosion of the business judgment rule is also likely to have additional costly effects for banks. Ultimately, such costs tighten the availability of credit, 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*

⁵ Chubb Group, *Worth the Risk? Highlights from the Chubb 2013 Private Company Risk Survey* at 9, available at <http://www.chubb.com/businesses/csi/chubb12192.pdf>.

⁶ *See id.*

Corp., 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, 48 1U.S. 69 (1987). Whereas “protecting directors’ reasonable risks is considered positive for the economy overall,” *Rosenfield v. Metals Selling Corp.*, 643 A.2d 1253, 1262 (Conn. 1994), as it allows banks (and other businesses) to “adapt to changing markets,” “capitalize on emerging trends,” and engage in beneficial innovation,” *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 the ABA’s recent survey reported that increased liability for directors and officers would likely lead to increases in the costs of loan evaluation and approval. [ABA survey results].

As a corollary effect, adoption of FDIC’s position would also exacerbate bank’s insurance-related costs. In the ABA’s recent survey, the legal environment was identified most consistently as the factor influencing changes to the terms of banks’ directors and officers liability coverage, including with respect to premiums, deductibles, and policy limits and scope. [ABA survey results] These results comport with historical trends in the market for liability coverage for directors and officers, where increased expense has arisen concurrently with changes to the law that potentially expanded directors’ and officers’ liability.⁷ In particular, when legal

⁷ See, e.g., Schatz, *Directors Feel the Legal Heat* (post-*Van Gorkom*, insurers “reacted by curtailing the amount of liability insurance they write, *Footnote continued on next page.*

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, 23-25 (1989). This can cause rates to rise, and if drastic enough, prompt insurers to drop out of the market. *See id.*

E. An Ordinary Negligence Standard Would Constrain Innovation and Distribution of Credit.

By balancing the need to allow directors and officers to make business decisions confidently with the need to protect shareholders and other constituents from serious misconduct, the business judgment rule encourages appropriate risk-taking in support of “innovation and venturesome business activity.” *Alford*, 318 N.C. at 299 n. 5. Beyond encumbering the market for qualified directors, breeding unwarranted litigation, and increasing bank costs, reducing the rule’s protections would undermine this very important benefit.

“A rule which penalizes the choice of seemingly riskier alternatives ... may not be in the interest of shareholders generally.” *Joy*, 692 F.2d at 886. Instead, “[b]usinesses—and particularly financial institutions—make returns by taking on risk.” *In re Citigroup Inc. Shareholder Derv. Litig.*, 964 A.2d 106, 126 (Del. Ch. 2009). Adopting what “appear[s] to be [an] ordinary

Footnote continued from previous page.
putting more exclusions in policies and raising the premiums, often by huge amounts”).

negligence [standard]” for director liability has a “perceived detrimental impact on director risk taking” and wealth creation. *First Union*, 2001 WL 18856686 at *11.

The impact of increased uncertainty about potential personal liability is exacerbated for “novel transactions” when “application of [the] standard [for liability] is in flux.” Romano, 14 Del. J. Corp. L. at 24. In the lending context, this will typically result in limiting a bank’s customer base 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. [ABA survey results]. Such a result is plainly contrary to sound public policy and banking objectives--“the availability of credit to consumers and business is critical to the efficient functioning of our economy.”⁸

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

Not only would FDIC’s position undermine the important policies supporting the business judgment rule, it also is untenable as a matter of law.

⁸ Federal Reserve Board of Governors, Press Release (Feb. 17, 2011), available at <http://www.federalreserve.gov/newsevents/press/other/20110217a.htm>.

FDIC disregards the authorities that the North Carolina Supreme Court would use to define the state's business judgment rule, opting instead to cite (and misapply) authorities from other states with no bearing on North Carolina's rule. As a result, FDIC advocates for a standard that contravenes the controlling authorities, all of which confirm that the business judgment rule bars ordinary negligence claims.

A. FDIC Relies Upon Authorities That North Carolina Courts Would Not Apply in Defining North Carolina's Business Judgment Rule.

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). This Court can supplement its understand of state law as warranted by other authorities that the state high court would consider, 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.

B. Applicable Authority Contravenes FDIC’s Position.

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 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, *see id.* (citing *Hawes v. Oakland*, 104 U.S. 450 (1882)), and its incorporation into state common law dates back at least as far as 1918. *Id.* (citing *Besseliew v. Brown*, 97 S.E. 743 (N.C. 1918)).

During this long history, North Carolina courts have repeatedly noted the business judgment rule’s importance. As they have recognized, the 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.” *Alford*, 349 S.E.2d 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.” *Alford*, 349 S.E.2d at 48 n.5 (citations omitted). Equally important, the business judgment rule frees directors and officers to pursue “risk-taking, innovation and venturesome business activity,” *id.* at 48 n.5; and that it “promote[s] corporate value.” *Custard*, No. 06 CVS 4622, 2010 WL 1035809, at *17.

North Carolina’s legislature also acknowledges the rule’s significance. In drafting the Business Corporation Act, the legislature had an opportunity to supplant the business judgment rule with its own standard. 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”). That the legislators decided to defer to the common law business judgment rule rather than supplant it is evidence that they recognized the rule’s value to North Carolina’s business environment and economy.

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 that 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) (citations omitted) (emphasis added). The court approved the “measure of liability” as articulated by the trial judge in the case then on appeal: that “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*, 76 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*, 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. Ann. §§ 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 “directors 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) (citation omitted) (emphasis added); *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. Ann. §§ 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*.

State v. Custard, No. 06 CVS 4622, 2010 WL 1035809, at *21 (N.C. Bus. Ct. Mar. 19, 2010) (“*Custard II*”) (emphasis added); *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 business decisions made in good faith, without conflict of interest, and by a rational and informed process. *Custard II*, 2010 WL 1035809, at *19, 26; *see also State v. Custard*, No. 06 CVS 4622, 2007 WL

2570241, *11 (N.C. Bus. Ct. Aug. 8, 2007) (“*Custard I*”) (“[n]o 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 *7-8 (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.* (citations omitted) (emphasis added).

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. This is 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*, 07 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 v. Baker*, No. CIV.A. 08 CVS 22632, 2008 WL 5124899, at *9 n.19 (N.C. Bus. Ct. Dec. 5, 2008). Thus, Delaware law is a source to which the North Carolina Supreme Court would look for persuasive authority in defining the business judgment rule.

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). Although directors 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); *see also In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 748 (Del. Ch. 2005) (“Because duty of care violations are actionable only if the directors acted with gross negligence, and because in most instances money damages are unavailable to a plaintiff who could

theoretically prove a duty of care violation, duty of care violations are rarely found.”) *aff’d*, 906 A.2d 27 (Del. 2006).

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. The weight of this extraordinary argument rest 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) (same language). Neither decision required the court to inquire into whether a standards of ordinary rather than 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 found that the alleged wrongdoing simply did not happen, avoiding any

consideration of negligence. 162 S.E. at 547.⁹ In contrast, North Carolina court decisions to have specifically discussed what standard of negligence applies, where that standard was relevant to the outcome of the case, held that plaintiffs must plead gross negligence to overcome the presumptions of the business judgment rule. *See supra* [].

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 considers allegations of fraud, not negligence. 74 S.E.2d 351, 355-56 (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 *Robinson on North Carolina Corporation Law* § 14.03. FDIC also cites *Robinson* for this argument, but the treatise suggests only that a higher standard "might" apply, pointing to a New York federal court decision applying *New York law* and a North

⁹ FDIC also misreads *Robinson*, contending the treatise supports its position. But the cited section merely states that the duties of directors "discussed in the preceding sections"—which described the duties of loyalty, good faith, and due care, as well as the business judgment rule—run directly to the corporation. 1 *Robinson on North Carolina Corporation Law* § 14.08. Thus, the treatise supports that potential director liability to a corporation is limited by business judgment rule, not that the corporate or derivative suits enjoy a lower pleading burden.

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.* (citing N.C. Gen. Stat. 53-82, now codified at N.C. Gen. Stat. 53C-4-6). FDIC also cites *Custard II*, but this decision 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.

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 interpreted its standard of review as gross negligence, even while acknowledging the state statutory standard of care. *See supra* []. In *Long*, for example, the North Carolina Court of Appeals, directly contradicting the FDIC’s argument, 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 *26.¹⁰

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 in evaluating claims against directors and officers. *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

¹⁰ *Resolution Trust Corp. v. Bernard*, No. 94-CV-475, 1995 WL 17164886, at *12 (M.D.N.C. Aug. 8, 1995), does not further FDIC’s argument. *Bernard* merely concluded that North Carolina “may” recognize director liability for simple negligence, but found that the law was “unsettled at best.” *Id.* at *11-12. *Bernard* cited to a section of the *Robinson* treatise that admits that it could not identify any on-point North Carolina decision holding that a gross negligence standard did not apply. *See 1 Robinson on North Carolina Corporation Law* § 14.03.

Supreme Court maintained that the business judgment rule continued to protect director and officer business decisions:

The 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.

Loudermilk, 761 S.E.2d at 338.¹¹ Thus, 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.

¹¹ Notably, *Loudermilk* held that the “business judgment rule applies equally at common law to corporate officers and directors generally and to bank officers and directors,” 761 S.E.2d at 338, undercutting FDIC’s argument to the contrary, *see supra* [].

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.* As a result, they enjoy “only 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, although risky, are likely to create value to the FDIC's interest in avoiding liability for losses that have already

been incurred. As a receiver for failed institutions and a deposit insurer, 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 a bank's upside potential. Instead, it 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. As Judge Posner has explained, stakeholders that "have no claim to the upper tail of the distribution of possible earnings," such as receivers or creditors, "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 prefers less risk than would be economically efficient in the sense of maximizing society's overall wealth.

FDIC does not, however, need the Court to mitigate its risk. Instead, it is uniquely positioned to protect its own interests. FDIC is the primary regulator of banks chartered by the states that do not join the Federal Reserve System, and has back-up supervisory authority for the remaining institutions for which it could be appointed receiver. As a regulator, 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 adoption of an easy pleading standard that would undermine the purposes of the business judgment rule.

Tailoring the business judgment rule to FDIC's interest is thus both illogical and needless. It is also unfair. The recovery available to any claimant on a receivership estate under FDIC's management is "unequivocally ... limited" 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,

/s/ Michael A.F. Johnson

Michael A.F. Johnson

Nancy L. Perkins

Elliot C. Mogul

Joanna G. Persio

ARNOLD & PORTER LLP

555 Twelfth Street, NW

Washington, DC 20004

(202) 942-5000

(202) 942-5999 (fax)

Michael.Johnson@aporter.com

Nancy.Perkins@aporter.com

Counsel for Amici Curiae

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 [] 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