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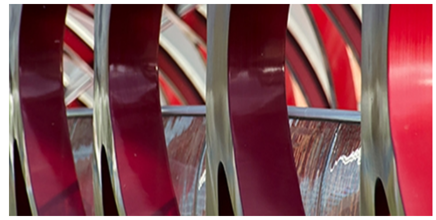

News & Types: Commercial, Competition & Trade Update

Ten Years After Crash, Litigation Continues – Directors of Bankrupt Holding Company not Liable to Trustee

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Practices: Commercial, Competition & Trade, Corporate, Finance & Acquisitions, Litigation

The Great Recession of 2008 may seem a distant memory. September 15, 2018 is the 10th anniversary of the Lehman Brothers bankruptcy, the largest bankruptcy in U.S. history, and often seen as the point at which a garden-variety recession turned into the Great Recession, with catastrophic results severely impacting the livelihood of millions.

Litigation resulting from the Great Recession is still ongoing. An example is a recent 7th Circuit Court of Appeals decision in which the officers of a failed bank holding company were found not liable to the company's trustee in bankruptcy for decisions that unsuccessfully tried to rescue the holding company's subsidiary banks. (*Elliott D. Levin, as Chapter 7 Trustee for Irwin Financial Corporation v. William I. Miller, Gregory F. Ehlinger, and Thomas D. Washburn*, 7th Circuit Court of Appeals, No. 17-1775, August 17, 2018)

Irwin Financial Corporation ("Irwin") was a holding company for two subsidiary banks, Irwin Union Bank and Trust Company (referred to in the decision as "Bank and Trust") and Irwin Union Bank, FSB (referred to as "Savings Bank"). Miller was Irwin's CEO and Ehlinger was its CFO. (The remaining defendant, Washburn, was not involved in the appeal.) These officers answered to Irwin's Board of Directors, which was largely independent. In fact, a supermajority of ten members of Irwin's Board were independent outside directors. After each meeting, the Board held an executive session without Irwin's officers.

In 2007-2008, the early stages of the financial crisis, both subsidiary banks struggled. Federal and state regulators insisted that Irwin had a duty to support its subsidiary banks. Irwin tried hard to do so. As part of its efforts to keep the subsidiary banks afloat, Irwin retained Rodgin Cohen of the law firm of Sullivan & Cromwell. Although not stated in the opinion, Cohen is known as one of the foremost legal experts in bank regulation, suggesting Irwin recognized the severe risks it was facing. Cohen agreed that Irwin should support the banks. The basis of his advice was the "Source of Strength Doctrine", which requires bank holding companies to provide assistance to subsidiaries in financial distress. Irwin's Board committed itself to saving the banks. As will be seen, this commitment, and actions taken consistent with this commitment, was later challenged by Irwin's bankruptcy trustee as a breach of fiduciary duty by Irwin's officers.

The situation worsened. In May 2008, the Chicago Federal Reserve and Indiana Department of Financial Institutions advised Irwin that the Bank and Trust was in trouble. Two months later the bank regulators sent a Memorandum of Understanding to Irwin demanding that Irwin obtain $50 million to support the Bank and Trust by the end of August. In the throes of the financial crisis hitting banks all over the country, this was an impossible demand and Irwin was unable to raise this money.

Irwin continued to try to support the banks through a formal Written Agreement to develop a plan to “improve management” and “maintain sufficient capital.” Irwin also tried to tap into funds from TARP (Troubled Asset Relief Program), one of the many alphabet soup programs offered to keep banks solvent during the Great Recession. In November 2008, Irwin submitted a TARP application to the Treasury Department. But, ironically, Irwin’s financial condition was almost too weak to justify TARP support to avoid throwing good money after bad.

In December 2008, Irwin injected $14 million into the Bank and Trust. There were positive indications that the Bank and Trust was not so bad as to prevent TARP assistance, although it would be an uphill struggle. The Federal Reserve again pushed for $50 million in additional funds into the Bank and Trust.

Irwin was desperate for TARP assistance and Irwin believed it needed Federal Reserve support for its application. In January 2009, Irwin asked the Federal Reserve what it needed for the Federal Reserve’s support. After, several weeks, the Federal Reserve responded that Irwin would need to raise an additional $150 million in capital, an impossible amount, as well as replace its CEO.

In the midst of this bleak situation, Irwin’s Board approved the 2009 Tax Allocation Agreement, which was the source of this litigation. As it had since 1999, the Agreement provided that Irwin would file consolidated federal income tax returns. If the banks would have become entitled to a tax refund if they had filed separately, Irwin would transfer the appropriate amount after receiving the refund from the IRS. This was also consistent with regulatory guidance applicable to bank holding companies. Fortuitously, Irwin was expecting a large tax refund to get it through these hard times.

While waiting for the tax refund, there was more bad news. On March 31, 2009, Irwin’s accounting firm, Ernst & Young informed Irwin that the Bank and Trust was no longer considered well capitalized and its ability to continue as a going concern was in serious doubt.

In May 2009, the Indiana Department of Financial Institutions, the FDIC and the Chicago Federal Reserve warned the Board’s independent directors of the consequences of failing to keep the Bank and Trust adequately capitalized. The Board continued to direct the officers to keep the banks solvent.

In June 2009, Irwin received the long-awaited tax refund. The refund was $76 million and, per the Tax Allocation Agreement, Irwin sent $74 million to the Bank and Trust and the remainder to the Savings Bank.

But, even with the tax refund, Irwin and its banks failed. Both banks closed and Irwin filed for bankruptcy in September 2009.

Levin, the plaintiff in this litigation, was appointed as Irwin’s Chapter 7 bankruptcy trustee. As trustee, he was charged with recovering as much as possible for the benefit of Irwin’s unsecured creditors.

Levin decided to pursue the officers of Irwin individually based on breach of fiduciary duty. Levin, second-guessing the Board and the officers, claimed that Irwin would have been better off to file bankruptcy *before* it transferred the refund to the subsidiary banks. Levin claimed that Miller and Ehlinger breached their fiduciary duties by failing to advise the Board of this possibility. The district court judge granted summary judgment to Irwin's officers and Levin appealed.

Judge Sykes, writing for the Court of Appeals, affirmed. First, Judge Sykes found the trustee's theory to be implausible. Levin's complicated scenario involved the officers of Irwin realizing the banks were doomed, investigating the bankruptcy option earlier, realizing that a bankrupt Irwin could probably keep the tax refund, and then advising the Board accordingly to file for bankruptcy before Irwin received the tax refund. Said Judge Sykes, "Color us skeptical."

There was a more fundamental flaw in Levin's theory, in Judge Sykes' view. Officers must follow the lawful instructions of the board, even if they disagree with those instructions. Irwin's Board's instructions were clear and were based on legal and regulatory guidance – first and foremost do everything possible to save the banks. Irwin's bankruptcy would have contradicted and probably destroyed this strategy. Judge Sykes noted, "The officers had no right – much less a duty – to pursue a course of action that directly contradicted the Board's clear instructions."

Consistent with the officers' duty to comply with the Board's instructions, the officers did not have any duty to hire an expert to second-guess the Board's judgment. Levin argued that the Board was persuadable and the officers should have done more to look into using Irwin's bankruptcy as a means to keep the $76 million tax refund. Judge Sykes dismissed this argument as "speculation", returning to the background around which all these events were taking place, namely the financial crisis that threatened, and ultimately destroyed, the banks and state and federal regulators' consistent demands to make every effort to save the banks.

So the trustee's efforts to use a fiduciary duty argument to impose personal liability on Irwin's officers failed. The case illustrates that, while the long, slow recovery from the financial crisis continues, efforts to shift the severe losses resulting from the financial crisis also continue and may still have a long way to go.