Maryland Bankers Association

Fiduciary Duties, Liability and Best Practices For Bank Directors and Officers

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LUSE GORMAN

Who We Are

Luse Gorman Pomerenk & Schick is a Washington, D.C. based law firm that specializes in representing community banks and other financial institutions

We are a national leader in representing community banks in mergers and acquisitions, capital raising transactions, mutual-to-stock conversions and mutual holding company reorganizations, executive compensation, regulatory and enforcement and general corporate and securities law

We represent over 250 financial institutions nationwide. Most are community banks ranging from $100 million to $30 billion in assets.

Some of Our Accomplishments

- No. 1 law firm in bank mergers and acquisitions in 2011 and 2009
- Top 10 law firm in bank mergers and acquisitions every year since 2001
- No. 1 law firm in community bank capital raising transactions since 2000.
- No. 1 in mutual-to-stock conversion and mutual holding company reorganizations since 2000

Topics Covered

1. Sources of Potential Liability
2. Fiduciary Duties
3. Recent Enforcement Data
4. Insurance and Indemnification
5. Best Practices

Sources of Liability

- Corporate laws of state of incorporation or charter
- State banking laws in which bank operates
- Federal banking laws
- Federal bank and S&L holding company laws
- Federal employee retirement plan laws (ERISA)
- Federal securities laws
- State securities laws

Sources of Liability - Example Institution

Maryland commercial bank, Delaware holding company, 401(k) Plan, privately held, non-SEC reporting

Sources of Potential Liability:

- Maryland banking laws (violation of law or regulation)
- Maryland securities laws (anti-fraud)
- Federal securities laws (anti-fraud)
- Delaware corporate laws (breaches of duty)
- FDIA (FDIC civil money penalties and damages)
- ERISA (failure of oversight of plan assets)

Personal Liability - Observations

- Directors and executive officers of typical bank have most potential personal liability of any business entity in U.S.
- Personal liability for corporate law breaches are extremely rare
- Structure, charter, ownership largely irrelevant with respect to potential personal liability – its all about the same
- Board fees largely irrelevant - liability not commensurate with pay, even unpaid directors can be liable
- Officers (as well as directors) have potential personal liability
- Insurance and/or indemnification not always permissible

Personal Liability - Observations

- Civil Money Penalties (CMPs) – FDIC, FRB, OCC may impose personal penalties on officers and directors for violations by the entity (bank or holding company)
- Civil Money Damages (CMDs)– FDIC may impose personal damages on officers, directors and affiliates for failures and loss to FDIC
- Historically, fraud, insider transactions or self-dealing was necessary but now negligence or lack of oversight can be result in liability
- Focus on FDIC fiduciary standards as "lowest common denominator"
- Process is key to demonstrating "care" and "diligence"

Fiduciary Duties - Observations

- Understand “delegation” versus “abdication”
- What would the “reasonable” person do?
- Most standards give directors the benefit of the doubt (some form of business judgment rule) as long as you have a good record and can demonstrate process
- Because process is key – 1) good minutes and records are critical and 2) you can and should rely on experts, and 3) select experts with care and review recommendations

Fiduciary Duties – FDIC Standards

Directors (and officers) owe duties of Loyalty and Care

Loyalty: must administer affairs with candor, personal and integrity, prohibited from advancing personal interests (and those of others) over bank's interests

Care: must act as prudent and diligent business persons, responsible for selecting, monitoring and evaluating competent management; monitoring and assessing business progress; establishing and monitoring adherence to policies; making decisions on the basis of fully informed meaningful deliberation; requiring management to provide timely and ample info

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Fiduciary Duties – Maryland Standards

Section 2-405.1 MD Corp Law:

Must perform duties in good faith, in manner reasonably believes to be in best interests of bank, with care of ordinarily prudent person under similar circumstances

May rely on any information, opinion, report, or statement by officer/employee they reasonably believe is reliable and competent, may rely on experts they reasonably believe are within expert's experience and committees of board they reasonably believe merit confidence

Law presumes satisfaction of duties

Fiduciary Duties – FDIC / MD Standards

Section 1821(k) of FIRREA

directors / officers may be personally liable for loss or damage caused by their "gross negligence," as defined by state law

FDIC v. Atherton

established principle that FDIC may pursue claims based on "simple negligence" (compared to gross or willful actions) if state law permits liability under lower standard

What does this mean for Maryland banks?

somewhat unclear but most commentators believe that due to legal presumption of satisfaction of duties that "gross negligence" would be needed for personal liability

Fiduciary Duties – Duty of Loyalty

- Check code of Business Conduct and Ethics (should address issues of conflicts for directors and employees)
- When in doubt - recuse yourself
- “Appearance” of interest = interest
- If many directors involved in transaction – use a committee of non-conflicted directors
- Over-disclose potential interests, family relationships and other affiliations

Fiduciary Duties – Duty of Care

- Inform yourselves with “all material information reasonably available” before making decisions

- What demonstrates Care?
  - Time spent preparing, investigating, deliberating
  - Sources of information for decision
  - Evidence of debate and questions
  - Sufficient advance notice of decisions
  - Advice of experts, counsel, financial advisors, etc.
  - Consideration of other alternatives
  - Critical review of reports and assumptions

Fiduciary Duties – Duty of Care

Reliance on management, experts and third parties:

- Board is authorized to “retain staff, outside counsel, independent accountants, financial advisors and other consultants” to assist in carrying out its duties and responsibilities
- Reliance is permitted unless the director has knowledge that the reliance in unwarranted (i.e., not reasonable to rely on expert)
- Board must exercise reasonable oversight and supervision over senior management

ERISA Fiduciary Duties

- ERISA covers employee pension & welfare benefit plans
- Highest standard of care known under the law - must act "**solely** in the best interests of plan participants and beneficiaries" when making ERISA fiduciary decisions
- Cannot act in best interest of bank or shareholders when making fiduciary decisions, not every decision is fiduciary decision
- ERISA fiduciary liability is <u>personal liability</u>

ERISA Fiduciary Duties

- If plan says “plan administrator” is “employer,” courts say every director is an “ERISA fiduciary”
  - 90%+ of plan documents name employer as fiduciary
  - If plan is silent, ERISA says employer is default fiduciary

- Board should appoint management level Benefits Committee as “ERISA fiduciary”
  - Directors / CEO should not be on Benefits Committee
  - Reduces number of comp items brought to board
  - Board must monitor Benefits Committee

- Committee should have charter to define scope of authority

Regulatory Actions - Themes

- Dishonest conduct or condoned abusive transactions with insiders
- Failure to adhere to laws and regs, bank’s policies or regulatory directives
- Failure to establish proper underwriting policies, monitor adherence thereto
- Approved loans they knew or had reason to know were improperly underwritten
- Outside directors – failure to heed warnings

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Civil Money Penalties – The Matrix

- CMP Matrix – helps examiners calculate fine

- Tier 1 – up to $5,500 per day
- Tier 2 – up to $27,500 per day
- Tier 3 – up to lesser of $1.1M or 1% of Assets

- "Examiners should recommend a specific money penalty… the financial benefit received by the insider should be given specific consideration

- Designed to punish and set examples, not to be remedial or make bank whole

Civil Money Penalties – The Matrix

CMP Matrix Factors Examiners Consider:

- Financial resources of individual
- Pecuniary gain / other benefit
- Previous violations or criticism
- History
- Loss to bank
- Continuation
- Concealment
- Impact
- Loss to stockholders / consumers
- Good Faith
- Cooperation

Recent Enforcement Activity

- CMPs and CMDs
- No clearinghouse for enforcement activity, need to review each agency’s public enforcement data
- Obvious trend – greater number of failures = greater number of enforcement actions
- Not so obvious trend – greater number of CMPs for compliance issues (not failure related)

Enforcement Actions By Regulator

	2007			2008			2009			2010			2011		
	Bank	Ind	**Total**	Bank	Ind	**Total**	Bank	Ind	**Total**	Bank	Ind	**Total**	Bank	Ind	**Total**
FDIC	161	52	**213**	220	69	**289**	486	96	**582**	624	173	**797**	425	139	**564**
FRB	22	13	**35**	45	45	**90**	189	75	**264**	251	52	**303**	141	35	**176**
OCC	91	234	**325**	143	331	**474**	216	285	**501**	227	222	**449**	184	221	**405**
OTS	40	15	**55**	68	19	**87**	183	73	**256**	192	72	**264**	111	72	**183**

Enforcement Against Individuals

	2007	2008	2009	2010	2011	Total
FDIC	10	7	21	36	42	116
FRB	1	1	0	0	2	4
OCC	46	20	22	48	22	158
OTS	1	5	22	26	39	93

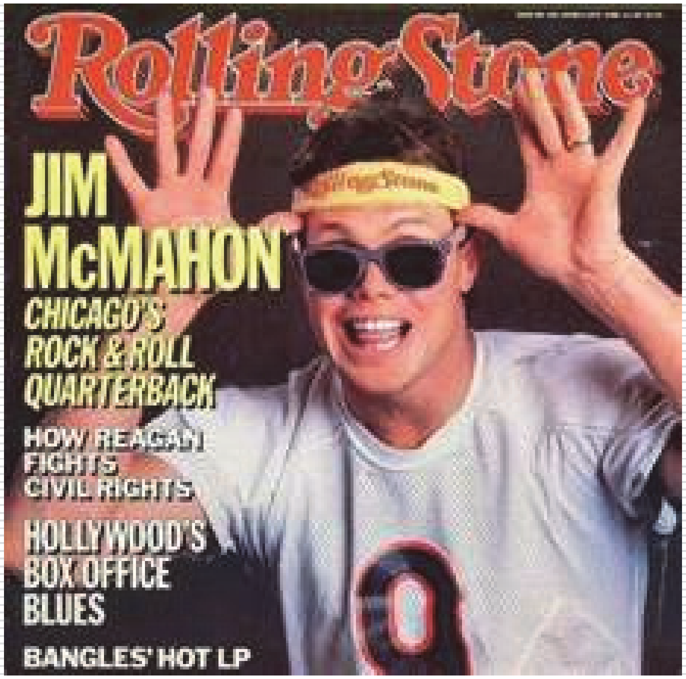
Adjudicated Enforcement

	2007	2008	2009	2010	2011
FDIC	1	0	2	0	0
FRB	0	0	0	0	0
OCC	2	1	0	0	0
OTS	n/a	n/a	n/a	1	1

Average Individual CMPs

	2007	2008	2009	2010	2011
OCC	$23,467	$35,350	$17,727	$ 6,883	$87,467
FDIC	$51,200	$12,714	$21,738	$22,569	$79,493
OTS	$10,000	$ 500	$ 8,795	$12,019	$15,333
FRB	$50,000	$15,000	$ 0	$ 0	$21,250

Example - FDIC v. McMahon (et al)



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FDIC v. McMahon (et al)

- FDIC (receiver of Broadway Bank) action to recover $104M from 9 directors / officers due to losses on 17 loans (overall $391M loss due to failure)

- Does <u>not</u> allege self-dealing or fraud, just really bad management

- Alleges "gross negligence, negligence and breaches of fiduciary duty" in approving "high-risk loans without regard to appropriate underwriting and credit administration practices, the Bank's written policies, federal lending regulations and warnings from the Bank's regulators"

- Officers named were on Loan Committee but not all directors named were on Loan Committee

FDIC v. McMahon (et al) – Some Quotes

- "CRE and ADC loans in excess of peers"
- "Many projects located outside state" (50%)
- "Not sufficient staff to monitor"
- "Failure to implement procedures to lessen risks"
- "Underwriting was perfunctory"
- "Internal loan limits ignored"
- "Grossly deficient appraisals"
- "Uncreditworthy borrowers with history of bad loans"
- "Warned by state and federal bank examiners"
- "Deferred excessively to the whims of the [owners]"
- "Important board meetings were frequently missed or ignored"

D&O Insurance and Indemnification

- Banks may not indemnify its directors and officers for payment of CMP or expenses associated with defending a CMP proceeding if the action results in a final order of assessment

- Banks may not agree to or enter into agreement to indemnify directors and officers – this means buying D&O insurance which has a CMP rider is a violation

- ERISA fiduciary liability insurance is available, may not be included in standard D&O liability insurance

Personal Liability – Civil Money Penalties

- Heightened liability when a board member executes a formal enforcement order
- If remedial action provided does not occur, the order is enforceable against an individual member of management or the board in their personal capacities, even if the person signed as a representative of the institution
- In imposing CMPs against a director, a bank regulator need not prove existence of underlying violation. Only needs to show failure to comply with the terms of the order

Personal Liability – Civil Money Penalties

- Important to establish a written record of steps a bank has taken to respond to regulatory concerns or disputes with regulatory findings, because only written facts that the bank regulator has before it are germane in any future court proceeding

Personal Liability – Civil Money Penalties

- If an institution does not stipulate to a formal order or CMP, bank regulator files a notice of charges with an administrative law judge (“ALJ”)
- ALJ then holds an administrative hearing and renders a decision
- If ALJ finds in favor of bank, bank regulator can appeal to agency head who can affirm or reject ALJ decision

Personal Liability – Civil Money Penalties

- Appeals from agency head are made to Federal Circuit Court of Appeals. Standard of review is "arbitrary and capricious" or "contrary to law". Burden of proof is shifted to bank or director on appeal.
- The process is expensive and ALJ is appointed by the bank regulator

Director Liability – Compensation Case Study

In re Goldman Sachs Group, Inc.

- Up to state case law to set corporate boundaries on an otherwise broad authority of a board. But as noted by the Delaware Chancery Court in *In re the Goldman Sachs Group, Inc. Shareholder Litigation* (October 12, 2011) "judges are ill-equipped by training… to second guess the business decisions of those chosen by stockholders to fulfill precisely that function."

In re Goldman Sachs Group, Inc.

Facts:

- Goldman had a “pay for performance” philosophy linking total compensation of employees to company performance
- Board approved a management-proposed compensation structure that compensated management based on a percentage of net revenue

In re Goldman Sachs Group, Inc.

- Management could maximize compensation by increasing net revenue and total stockholders equity
- Plaintiffs alleged that this compensation structure led management to pursue a highly risky business strategy that emphasized short-term profits in order to increase yearly bonuses

In re Goldman Sachs Group, Inc.

- Plaintiffs also argued that this strategy was not in the best interests of stockholders, in part because stockholders did not benefit to same degree as management did
- Stockholders received roughly 2% of the revenue generated in the form of dividends, but if investments went south, it was stockholders' equity at risk
- Goldman had an audit committee in charge of overseeing risk

In re Goldman Sachs Group, Inc.

Plaintiffs’ legal claims:

Goldman directors breached fiduciary duties by:

- Failing to properly analyze and rationally set compensation levels for Goldman employees;
- Committing waste by approving a compensation ratio for Goldman employees in an amount so “disproportionately large to the contribution of management, as opposed to capital, as to be unconscionable”

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In re Goldman Sachs Group, Inc.

Plaintiffs also claimed that the directors violated their fiduciary duties by failing to adequately monitor Goldman's operations and by "allowing the firm to manage and conduct the firm's trading in a grossly unethical manner."

In re Goldman Sachs Group, Inc.

In dismissing plaintiffs claim the Delaware Chancery Court stated:

> "Oversight duties under Delaware law are not designed to subject directors, even expert directors, to personal liability for failure to predict the future and to properly evaluate business risk."

In re Goldman Sachs Group, Inc.

- The plaintiffs did not indicate that the Goldman directors did not keep themselves reasonably informed or did not fulfill their duty of oversight in good faith.
- Good faith, not a good result, is what is required of the board

In re Goldman Sachs Group, Inc.

- Goldman's charter had an 8 Del. C. §102(b)(7) provision providing that the directors are exculpated from liability except for claims based on "bad faith" conduct.
- Therefore, plaintiffs needed to plead "particularized facts that demonstrate that there was and intentional dereliction of duty or conscious disregard for their responsibilities, amounting to bad faith."

Typical Trouble Spots

- Repeat violations of law and regulation
- Failure to have systems and procedures to address risks
- Insider loans or transactions
- Inadequate records to “prove” diligence and oversight

Best Practice Issues

- Board / Committee Minutes and Agendas
- Independence Monitoring and Testing
- Use of Board Committees
- Dialogue with Regulators

Board Best Practices

Recommended Policies

- Policies should govern the following areas of operations:
  - Investments
  - Loans
  - Asset/liability and funds management
  - Internal controls
  - Audit
  - Conflicts of interest / Code of Ethics
  - Compliance and CRA
  - Specialty areas, e.g., BSA, IT, etc.

Drafting and Keeping Minutes

- Two schools – long-form detailed or short-form summary
- Arguments for short form:
- Arguments for long form:

Fiduciary Duties – Duty of Care

Board Meeting Agenda

- Careful, comprehensive, and consistent preparation of an agenda for each meeting provides board members with reasonable assurance that all important matters are brought to their attention
- Packets should be received several days prior to the meeting and thoroughly reviewed

Recent Words of Wisdom

- “Inadequate systems and controls were a primary reason for the recent problems”

- “Some of our most seasoned supervisors, people with 30 or more years of experience in some cases, tell me that this is the first time they have seen operational risk eclipse credit risk as a safety and soundness challenge. Rising operational risk concerns them, it concerns me, and it should concern you."

Tom Curry, Comptroller of the Currency, May 16, 2012

Basic Operating Tenants

- Be informed
- Be active
- Be prepared
- Be reasonable
- When in doubt - don’t

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