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LEGAL UPDATES AND NEWS

NCUA Issues Final Rule on Fiduciary Duties of Credit Union Directors

On December 16, 2010, the Board of the National Credit Union Administration ("NCUA") approved a final rule regarding the fiduciary duties of federal credit union ("FCU") directors in order to provide a uniform rule for FCUs.[1] The final rule adds a new Section 701.4 to the NCUA's regulations that sets forth the authorities and responsibilities of directors. Additionally, the final rule amends Section 701.33 of the NCUA's existing regulations to prohibit FCUs from indemnifying officials or employees for actions that affect the fundamental rights of members and are determined to be grossly negligent, reckless, or willful.

The new rule (Section 701.4(a)) provides that the board of directors is responsible for the "general direction and control of the affairs" of an FCU and that, although the board may delegate operational functions to FCU personnel, the board's "ultimate responsibility" over the FCU's direction and control is non-delegable. The NCUA explains in the preamble to the final rule that while directors do not actually manage the credit union, they retain statutory responsibility for its proper management. This rule essentially restates a general principle of corporate governance.

The rule (Section 701.4(b)) also sets forth the basic fiduciary duties of FCU directors, which include the duty to "[c]arry out his or her duties as a director in good faith, in a manner such director reasonably believes to be in the best interests of the membership of the Federal credit union as a whole, and with the care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." This standard encompasses the duties of care and loyalty and incorporates language from the Model Business Corporation Act. The preamble to the final rule emphasizes that the directors' duties flow to the credit union's members (as opposed to only the institution) and that the directors must consider the interests of the membership *as a whole* when making decisions that affect the credit union.

Consistent with this principle, the rule (Section 701.4(b)(2)) requires that each director has a duty to administer the affairs of the FCU "fairly and impartially and without discrimination in favor of or against any particular member." The preamble notes that this language does not create a federal cause of action in favor of particular individuals or groups of individuals.

The rule (Section 701.4(b)(3)) also requires each director to have, at the time of election or appointment (or within six months thereafter), "at least a working familiarity with basic finance and accounting practices, including the ability to read and understand the Federal credit union's balance sheet and income statement and to ask, as appropriate, substantive questions of management and the internal and external auditors." The final rule does not establish specific requirements for

[1] The final rule also addresses credit union-to-bank mergers and charter and insurance conversions; however, this newsletter is limited to discussing the provisions affecting directors' fiduciary duties.

financial and accounting knowledge, but notes in the preamble that the "level of necessary literacy depends on the size and complexity of the FCU."

Section 701.4(b)(4) sets forth the duty of each director to "[d]irect management's operations of the Federal credit union in conformity with the requirements set forth in the Federal Credit Union Act, this chapter, other applicable law, and sound business practices."

Consistent with general principles of corporate governance, the rule (Section 701.4(c)(1)) authorizes the board and its committees to retain staff and outside counsel, independent accountants, financial advisors, and other outside consultants at the FCU's expense. Under the rule, FCU staff providing services to the board or a committee thereof may be required to report directly to the board or the committee, and the preamble to the final rule notes that the board "is free to ask any manager, employee, or independent contractor to provide the board and its committees information directly and not through the filter of the CEO." The rule (Section 701.4(c)(3)) states that in discharging board or committee duties, a director is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by any of the parties listed above, so long as the director "does not have knowledge that makes reliance unwarranted."

The rule (Section 701.4(d)) also addresses the authority of directors to rely on information provided by others. Specifically, it provides that a director may rely on (i) officers or employees of the credit union who the director "reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided"; (ii) attorneys, accountants, and other persons retained by the FCU as to matters within the particular person's professional and expert competence and "as to which the particular person merits confidence"; and (iii) a committee of the board of which the director is not a member, if the director reasonably believes that the committee merits confidence.

In response to commenters who asked about the interplay between the new regulation and the business judgment rule (which generally protects directors from liability for business decisions undertaken in good faith), the NCUA stated that because the final rule does not create an express or implied private right of action, a potential litigant would be required to look to state law to establish a cause of action, and the existence and form of any business judgment rule would depend on the law of the state in which the claim was brought. The NCUA also expressed its position that the business judgment rule does not apply to administrative enforcement actions brought by the agency.

Finally, the final rule amends Section 701.33 of the NCUA's existing regulations to prohibit an FCU from indemnifying an official or employee for personal liability relating to any decision on a matter significantly affecting the fundamental rights and interests of the FCU's members where the decision is determined by a court to have constituted gross negligence, recklessness, or willful misconduct. The final rule specifies that charter and deposit insurance conversions and terminations constitute "matters affecting the fundamental rights and interests" of FCU members. The final rule permits an FCU to advance funds to pay or reimburse legal fees and other expenses incurred by the official or employee, provided that the board makes a good faith determination that the individual acted in good faith, the payments will not materially adversely affect the FCU's safety or soundness, and the individual agrees to reimburse the FCU if he or she ultimately is found to be not entitled to indemnification. Additionally, the final rule includes corresponding amendments to the indemnification provisions contained in the standard bylaws of FCUs and corporate credit unions.

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Luse Gorman is a Washington, D.C.-based law firm that represents banks, thrifts and credit unions on a national basis on regulatory, corporate and securities matters. Luse Gorman regularly advises clients on fiduciary duty matters. For further details regarding this newsletter, please contact any of the attorneys listed below.

Richard S. Garabedian ■ (202) 274-2030
Kent M. Krudys ■ (202) 274-2019
Lawrence Spaccasi ■ (202) 274-2037