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

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Topics Covered

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

Sources of Director and Officer 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

Personal Liability - Observations

- Directors and executive officers of a bank have most potential personal liability of any business entity in U.S.
- Personal liability for corporate law breaches are rare
- Structure, charter, ownership largely irrelevant with respect to potential personal liability
- Board fees are 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) – Regulators may impose personal penalties on officers / directors for violations by entity or individual
- Civil Money Damages (CMDs)– FDIC may impose personal damages on officers, directors and affiliates for failure 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”
- Ask - What would the <u>reasonable</u> person do?
- Most standards give officers and directors <u>benefit of the doubt</u> (some form of business judgment rule) as long as you have good record and can demonstrate “process”
- Because <u>process is key</u> - 1) good <u>minutes and records</u> are critical and 2) you can and should <u>rely</u> on experts and management (as long as reliance is reasonable)

Fiduciary Duties – FDIC Standards

Directors / Officers owe duties of Loyalty and Care

Loyalty: must administer affairs with candor and personal integrity, prohibited from advancing personal interests (and/or 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

Fiduciary Duties – PA Standard(1712,Pa.C.S.)

Directors - must discharge duties: 1) in good faith, 2) in manner they reasonably believe to be in best interests of bank, 3) with such care, including reasonable inquiry skill and diligence an ordinarily person would use under similar circumstances

Reliance on others - may rely on information, opinions or reports by: 1) employees reasonably believed reliable and competent, 2) legal counsel, public accountants they reasonably believed within expert's competence, and 3) committees reasonably believed to merit confidence

Effect of Actual Knowledge – not "good faith" if actual knowledge of facts that would cause reliance to be unwarranted

Officers – unless bylaws provide otherwise, must discharge duties: 1) in good faith, 2) in manner they reasonably believe to be in best interests of bank, 3) with such care, including reasonable inquiry skill and diligence an ordinarily person would use under similar circumstances

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Fiduciary Duties – FDIC / PA 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 Pennsylvania Banks?

Fiduciary Duties – Duty of Loyalty

- Check code of Business Conduct and Ethics (should address issues of conflicts for directors and employees)

- When in doubt - <u>recuse</u> yourself

- "<u>Appearance</u>" of interest = interest

- If many directors involved in transaction – use a <u>committee</u> of non-conflicted directors to decide

- <u>Over-disclose</u> potential interests, family relationships and other "interested" affiliations

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Fiduciary Duties – Duty of Care

- Inform yourselves with "all material information <u>reasonably</u> available" before making decisions

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

Fiduciary Duties – Duty of Care

Reliance on management, experts and third parties:

- Board authorized to retain staff, outside counsel, independent accountants, financial advisors and other consultants in carrying out its duties and responsibilities
- Reliance is permitted unless director has knowledge that reliance is unwarranted (i.e., <u>not reasonable</u>)
- Board must exercise reasonable oversight and supervision over senior management
- Board <u>may not blindly accept</u> reports or recommendations – check assumptions and projections

Fiduciary Duties - ERISA

- 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 personal liability

Fiduciary Duties - ERISA

- 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”
  - <u>Directors / CEO should not be on Benefits Committee</u>
  - Reduces number of comp items brought to board
  - Board must monitor Benefits Committee
  - Committee should have charter to define scope of authority

- Board / Officers <u>should not be plan “trustees”,</u> if possible

Regulatory Actions - Themes

- Fraud or dishonest conduct
- Condoned or approved abusive transactions with insiders
- Failed to adhere to bank's policies or regulatory directives
- Failed to establish "prudent" underwriting policies, monitor adherence thereto
- Approved loans they knew or had reason to know were improperly underwritten
- Outside directors – failure to heed warnings and directives

Civil Money Penalties – The Matrix

- CMPs designed to punish and ensure future compliance, not meant to be remedial or make bank whole

- CMP Matrix – helps regulators 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”

Civil Money Penalties – The Matrix

CMP Matrix Factors Regulators Must Consider:

- Intent
- Financial resources of individual
- Pecuniary gain / other benefit
- Previous violations or criticism
- History of bank and board
- Loss to bank
- Number and Duration of Violations
- Continuation after notification
- Concealment
- Impact
- Loss to consumers
- Restitution
- Good Faith
- Cooperation

Civil Money Penalties – When Under an Order

- Heightened liability when formal enforcement order exists
- If remedial action does not occur, order is enforceable against individual in their personal capacities, even if signed as "representative" of institution
- In imposing CMPs, regulator need not prove existence of underlying violation, only need to show failure to comply with order
- Important to establish written record of remedial actions, concerns and disputes with regulatory findings – will be critical in court proceeding

Civil Money Penalties - Appeal

- Process is expensive and ALJ is appointed by the bank regulator
- Appeals from ALJ 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 individual on appeal

Recent Enforcement Activity

- CMPs and CMDs
- No clearinghouse for enforcement activity, need to review each agency's public enforcement data
- Obvious trend – bad economic times means greater number of failures and 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**

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Enforcement – Directors and Officers

	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

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Enforcement – Adjudicated Actions

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

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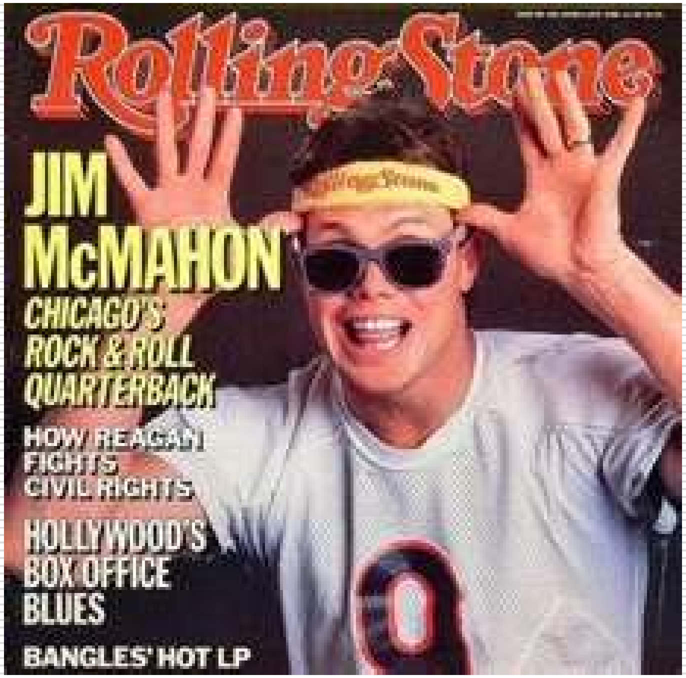
Example - FDIC v. McMahon (et al)



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 <u>really bad management</u>

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

- Officers named were on Loan Committee but <u>not all directors named were on Loan Committee</u>

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 <u>may not indemnify</u> 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 <u>may not enter into agreement</u> to indemnify directors and officers – buying D&O insurance which has a CMP rider <u>is a violation</u> (legal expenses are OK and directors can buy)

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

- Make sure charter and bylaws are up to date

Best Practice Issues

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

Board / Committee Minutes and Agendas

- Minutes are best record to show what was done or not done
- When sued - how and what you do with drafts, notes and preparation materials is just as important as final product
- Minutes of committees are equally as important as full board minutes
- Drafting good minutes is an art - there should be some training and they should be reviewed by counsel periodically
- Two schools – long-form detailed or short-form summary

Board / Committee Minutes and Agendas

Long Form Versus Short Form:

- Arguments for long-form - if done right, will demonstrate most accurate record of what was deliberated on, considered and what was said by each of the participants
- Arguments for short form - if done right, will show record of the substance of what was deliberated upon and covered but with ability to "fill in the blanks" in the context of regulatory or litigation at hand, will not have to deal with specific "testimony" that may (will!) be taken out of context

Board / Committee Minutes and Agendas

Board Meeting Agendas and Pre-Meeting Distribution

- 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 <u>several days</u> prior to the meeting and thoroughly reviewed
- Minutes should <u>reflect that materials were distributed</u> in advance of meeting

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Board / Committee Minutes and Agendas

- Prepare as soon after meeting as possible
- Be careful with drafts – destroy notes and prep materials
- Be complete about what was discussed but precise
- Capture substance of inquiry – <u>not who said what</u>
- Note time devoted to meeting but not particular subject
- Note comings and goings of participants
- Note reliance on advisors reports, memoranda and analysis
- Note advisor question and answer period
- Use specific resolutions as much as possible
- Note review of committee minutes and recommendations
- Set clear document retention policies
- Be careful with special situations (conflicts, privilege)

Special Board Committees

- Board should consider using special board committee in special circumstances (mergers and acquisitions, conflicts involving many board members, litigation, regulatory problems)

- Composition of special committee should consider independence issues and skills of board members

- Full board minutes that establish the committee should address selection considerations and criteria

Director Independence

- Board should have policy on board independence and periodic testing of independence (Corporate Governance Committee)
- Independence should be more than just "not an employee," NASDAQ standards are good start ($120K/$200k /5% tests)
- Annual board questionnaire should be prepared and reviewed
- Audit, Nominating and Compensation Committees are most sensitive to independence issues – charters should address
- Independent Board executive session at least 2 times a year

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Dialogue With Regulators

- <u>More is More</u> – more communication and questions are better

- When in doubt – ask examiners, but do your homework before you ask

- Make sure communications and questions are agreed to by board - do not “lone ranger” or “go rogue”

- Keep a <u>record of all communication</u> (including emails and calls) no matter how insignificant you think it may be

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