ABA Mega Conference

D&O Update: A Review of Director Duties, Best Practices, Enforcement and Litigation Trends

Robert T. Smith
Why would anyone sane be a bank director?

- Thomas P. Vartanian, Wall Street Journal, August 28, 2017
Response of Congress and federal regulatory agencies to every financial crisis over the past four decades has been to “improve” bank regulation by increasing it.

“Rising dough” syndrome of regulation:
- A continuing expansion of regulatory obligations imposed on directors, and a corresponding expansion of the basis for lawsuits against them.
Author applauds the Fed and Treasury for recent guidance, but says the federal agencies miss the mark by:

- Failing to focus on the most important challenge to directors – balancing making an objectively measurable profit with the subjective determination of how much risk the bank should take.
- Taking aggressive actions against directors of failed institutions regardless of how the directors acted.
3 Origins of Personal Liability

- Shareholder claims / breach of fiduciary duty
- Regulatory Enforcement Actions (pre-failure)
- FDIC lawsuits (post-failure)
Shareholder Lawsuits in the Financial Industry
Shareholder Lawsuits in the Financial Industry

- Common claims – “false and misleading statements”
- 2017 has seen a record number of class action suits
- Of all class action suits since 1996, 48% have settled, 42% were dismissed, and 10% are ongoing; less than 1% will reach a verdict
Shareholder Lawsuits in the Financial Industry

- BNC Bancorp (North Carolina):
  - Sale to Pinnacle Financial
  - Suit filed against BNC and its directors alleging failure to seek other potential buyers
  - Alleged failure to disclose board compensation post-closing
Shareholder Lawsuits in the Financial Industry

- Florida Bank Group ($500m assets):
  - Significant losses 2007 - 2013
  - Private placement in 2013
  - Sold to Iberia in 2015
  - Shareholder suit filed in 2017
  - Allegations of insider dealings to dilute minority owners
  - Alleged failure to disclose potential sale in connection with 2013 stock offering

- Disclosure, disclosure, disclosure
Regulatory Enforcement Actions
# Federal Enforcement Actions

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<th>Year</th>
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Types of Regulatory Enforcement Actions

- Informal actions
  - (1) Board Resolutions
    - “when a bank’s overall condition is sound, but it is necessary to obtain written commitments from a bank’s board of directors to ensure that identified problems and weaknesses will be corrected” (OCC PPM 5310-3)
  - (2) Memorandum of Understanding
    - Regulator has “reason to believe that a board resolution would not adequately address the deficiencies noted during an examination” (FDIC Compliance Manual)
Types of Regulatory Enforcement Actions Cont.

- Formal actions
  
  - (1) Civil Money Penalties (CMP)
    
    - Violation of law or regulation, breach of fiduciary duty, unsafe/unsound practices
    
    - To sanction an institution or IAP according to degree of culpability and severity of violation
Types of Regulatory Enforcement Actions Cont.

- (3) Cease & Desist
  - To halt violations of law and/or require affirmative corrective action
  - Examples: restitution, changes to management, capital directives, restricted growth
  - Referred to as a "Consent Order" if stipulated to by the institution or IAP

- (4) Removal / Suspension of Institution Affiliated Party (IAP)
  - IAP: director, officer, employee, controlling stockholder, contractor
Enforcement Actions

• Enforcement actions are “bank specific” – based upon findings in an examination or a failure to follow previous directives

• May also indicate regulatory focus on particular issues or current market conditions
Observations on Recent Regulatory Enforcement Actions

- Deloitte Center For Financial Services

- Spike in 2005 mainly due to Enforcement Actions (EA) against individuals (IAPs)

- 2010 was busiest year with FDIC (44%) issuing the highest number of EAs

- Severe EAs (C&D Orders, Formal Agreements and Prompt Corrective Actions) represented a majority of all EAs during 2009 and 2010
Observations on Recent Regulatory Enforcement Actions

- Proportion of severe EAs has steadily declined since 2010
  - **Reasons**: (1) failure of weaker institutions; (2) better market conditions; (3) more robust compliance by banks

- Severe EAs as a percentage of total EAs:
  - 2007 – 20%
  - 2010 – 56%
  - 2013 – 22%
  - 2016 – 16%

- Types of EAs by regulator:
  - FDIC – 43% of EAs were C&D Orders
  - Fed – 74% of EAs were Formal Agreements
Observations on Recent Regulatory Enforcement Actions

Deloitte Center For Financial Services

Mid-sized institutions ($10b to $50b in assets)

- only 5% of EAs since 2000
- 77% of EAs were sanctions against individuals
Observations on Recent Regulatory Enforcement Actions

- Small institutions (assets less than $10b)
  - More than 5,500 small institutions have received an EA since 2000
  - The average per bank is lower than that for mid-sized and large banks
  - Small: 1.9 per bank
  - Midsized: 5.1 per bank
  - Large: 29.2 per bank (large % were against IAPs)
  - Majority of small bank EAs were against institutions, not IAPs
Observations on Recent Regulatory Enforcement Actions

- Main reasons for Severe EAs (C&D Orders, Formal Agreements and Prompt Corrective Actions):
  - Deficiencies in residential mortgage servicing and foreclosure practice
  - Violation of Bank Secrecy Act and Anti-money laundering compliance
  - Weakness in financial condition
Federal Enforcement Actions

Prior 12-months

- 279 enforcement actions

Most common issues:

- 13.2% - BSA / AML compliance
- 23.4% - unfair, deceptive or abusive acts or practices (UDAAP)
- 7.5% - national flood insurance program
Federal Enforcement Actions

Outlook / areas of concentration:

1. Consumer protection
2. BSA / AML
3. Unfair / Deceptive consumer practices
4. Cybersecurity *(FDIC strategic plan to increase staffing/enforcement)*
5. Vendor risk management

“. . . the Board shall enhance its participation in the affairs of the Bank”
Federal Enforcement Actions

Removal of Institution Affiliated Parties

- Repeated violations of loan policy
- Accommodation to long-time credit customer
- Insider dealings (loans to related parties)
Recent Fed Guidance
- Proposal issued on August 3, 2017, regarding Fed’s supervisory expectations for bank boards

- 3 Components:
  - New Guidance on Board Expectations
    - Describes effective boards as those that:
      - set clear, aligned and consistent direction regarding strategy and risk tolerance
      - actively manage information and flow and board discussions
      - hold senior management accountable
      - support independence of risk management and internal audit, and maintain a capable board composition and governance structure
Recent Fed Guidance

- **Revisions or Rescission of Existing Guidance:**
  - Proposal would “slim down” Board responsibilities to create better distinction between Board and executives

- **New Practice for Communicating Supervisory Findings:**
  - Proposal would limit the circumstances in which the Fed will communicate supervisory Matters Requiring Attention (MRAs) and Matters Requiring Immediate Attention (MRIAs) directly to the Board.
Federal Enforcement Actions
Recent Example – compensation committee

- OCC action against director and senior VP of First National Bank of Waupaca, Wisconsin
- Employed for over 30-years; close relationship with President; President was indebted to the director
- Served on Compensation Committee
- “failed to oversee or control use of Bank’s funds by [the President] for his personal expenses”
- “failed to ensure that disinterested and independent directors determined and approved [President’s] compensation” and allowed him to receive “excessive compensation”; failed to recuse herself from approving compensation
- OCC imposed civil penalty
- Notes: enhanced focus on compensation issues, importance of independence
FDIC Litigation
FDIC: Financial Institution Letter 87-92

- Types of lawsuits filed by FDIC:
  - Cases where the director or officer engaged in dishonest conduct or approved or condoned abusive transactions with insiders;
  - Cases where a director or officer was responsible for the failure of an institution to adhere to applicable laws and regulations, its own policies or an agreement with a supervisory authority, or where the director or officer otherwise participated in a safety or soundness violation; and
FDIC: Financial Institution Letter 87-92

- Types of lawsuits filed by FDIC:

  - Cases where directors failed to establish proper underwriting policies and to monitor adherence thereto, or approved loans that they knew or had reason to know were improperly underwritten, or, in the case of outside directors, where the board failed to heed warnings from regulators or professional advisors, or where officers either failed to adhere to such policies or otherwise engaged in improper extensions of credit.

  - Examples of improper underwriting have included lending to a borrower without obtaining adequate financial information, where the collateral was obviously inadequate, or where the borrower clearly lacked the ability to pay.
FDIC: Financial Institution Letter 87-92

- FDIC distinguished between inside and outside directors

- An inside director is generally an officer of the institution, or a member of a control group.

- An inside director generally has greater knowledge of and direct day to day responsibility for the management of the institution.
- An outside director usually has no connection to the bank other than as a small shareholder. Outside directors generally do not participate in the conduct of the day to day business operations of the institution.
The most common suits brought against outside directors either involve insider abuse or situations where the directors failed to heed warnings from regulators, accountants, attorneys or others that there was a significant problem in the bank which required correction. In the latter instance, if the directors fail to take steps to implement corrective measures, and the problem continued, the directors may be held liable for losses incurred after the warnings were given.

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FDIC Litigation: Champion Bank (Missouri)

- Champion Bank: De novo – August, 2006
- Asset Growth: August 2006 - $15.4m / December 2007 - $224m
- By March, 2008, out of territory lending = 311% of Tier 1 Capital
- Purchased large participations in Nevada, Arizona
- “with little or no independent underwriting”
- Failed to follow own lending policies
- Management unable to assess feasibility of out-of-territory projects
- FDIC sued 10 officers/directors individually
- Filed April 29, 2013
FDIC Litigation: Champion Bank (Missouri)

24. Under Champion’s Credit Policy the following loan characteristics were deemed undesirable:

   a. The borrower has no deposit relationships with the Bank.

   b. The source of repayment is unclear or unstable.

   c. The borrower invests an insignificant amount of equity in the project or makes an insignificant down payment.

   d. The borrower has a history of delinquency or no established credit record.

   e. The borrower resides outside of the Bank’s local community and has never been a member of the community.
34. Defendants engaged in negligence, gross negligence, and breach of fiduciary duty in that, among other things, they:

a. Recommended and approved speculative out-of-territory participations with little or no independent underwriting in violation of federal regulation and Champion’s Credit Policy;

b. Recommended and approved speculative out-of-territory participations where the obligors were unable to repay the obligation to the lead bank;

c. Recommended and approved out-of-territory participations that were substantially undercollateralized and which were based upon a speculative future value of the property;

d. Recommended and approved speculative out-of-territory participations in projects located in steeply declining markets at a time when other banks were seeking to minimize their exposure to such projects;
Material Loss Review – Office of Inspector General (FDIC)

- Capitol City Bank & Trust, Atlanta, Georgia

- September, 2015

- The bank “failed primarily because its Board and management did not properly manage the risks associated with the bank’s growth strategy that was centered on higher-risk CRE loans”

  - “Deficient loan underwriting and credit administration practices such as over-reliance on collateral, lack of borrower financial information, and continued loan renewals negatively impacted the CRE loan portfolio.”
Material Loss Review – Office of Inspector General (FDIC)

Capitol City Bank – CRE loans / total capital:
- 2006 - 528%
- 2010 - 1,212%
- 2014 - 2,283%
Material Loss Review – Office of Inspector General (FDIC)

- Buckhead Community Bank, Atlanta, Georgia
- Closed in December, 2009
  - The bank “failed because the bank's Board and management did not implement adequate controls to identify, measure, monitor, and control the risks associated with the bank's significant acquisition, development and construction loan concentration."

- ADC loan growth of over 400% between 2004 to 2007
FDIC Litigation – Buckhead Community Bank

- Bank closed on December 4, 2009
- FDIC lawsuit filed in November, 2012
  - Allegations: "defendants engaged in numerous, repeated, and obvious breaches of the Bank's Loan Policy, underwriting requirements and banking regulations, and prudent and sound banking practices"
- Defendants included – local real estate agent, President of the local Country Club, local hotel owner, Waffle House franchisee
Buckhead Cont.

- Defense attorney: no evidence of fraud, no self dealing

- FDIC's argument: defendants collectively owned 30% of the bank, and stood to gain from its growth; in an effort to grow the bank and line their own pockets, the defendants approved loans in violation of bank policies and prudent banking practices

- Important for question of applicability of business judgment rule

- October 25, 2016 – Jury verdict against former officers and directors

- Damages: $4.98 million
Fiduciary Duties
- Directors and Officers owe three basic fiduciary duties to a corporation, its shareholders *and creditors*:
  - Duty of Care
  - Duty of Loyalty
  - Duty of Oversight
FDIC: Financial Institution Letter 87-92

- Confirmed duties of care and loyalty as applicable to bank directors and officers

  - Duty of Care: “to act as prudent and diligent business persons in conducting” the affairs of the bank

  - Duty of Loyalty: “to administer the affairs of the bank with candor, personal honesty and integrity”

- Director Responsibilities: (i) selecting, monitoring, and evaluating competent management; (ii) establishing business strategies and policies; (iii) monitoring and assessing the progress of business operations; (iv) establishing and monitoring adherence to policies and procedures required by statute, regulation, and principles of safety and soundness; and (v) for making business decisions on the basis of fully informed and meaningful deliberation.
Officer Responsibilities: Officers are responsible for running the day to day operations of the institution in compliance with applicable laws, rules, regulations and the principles of safety and soundness.
BUSINESS JUDGMENT RULE

- “In the inherently risky environment of business, boards of directors need to be free to take risks without a constant fear of lawsuits affecting their judgment.”
  - Delaware Supreme Court

- The business judgment rule (“BJR”) insulates Directors against personal liability for their negligent conduct in decision making. The BJR creates a presumption in favor of Directors that in making a decision the Directors acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interest of the Corporation.
CULPABILITY UNDER THE BUSINESS JUDGMENT RULE

- Directors are culpable only in the case of gross negligence

- Director liability for gross negligence may be limited by the Corporation under its charter

- In such instances, Directors will only be liable for decisions made in “bad faith.”
Handling Conflict Situations To Avoid Breach Of Duty Of Loyalty

- Conflicts of interest do not per se result in a breach of the duty of loyalty.

- It is the manner in which the conflict is handled by the Director that controls. *Ark. Code Ann. § 4-27-831*

- Importance of approval by independent directors
Duty Of Oversight

- Duty of preventing corporate wrongdoing

- Duty requires that Directors:
  - Keep themselves informed about the activities of the Bank;
  - In good faith, satisfy themselves that the Bank has in place effective internal systems for detecting and preventing corporate wrongdoing; and
  - Appropriately monitor the effectiveness of the internal reporting and legal compliance systems.
Limiting your liability
How to limit liability as a bank officer or director:

- Elimination of personal liability in Charter
- Indemnification and Advancement provisions in Bylaws
- D&O Insurance
- FDIC FIL-47-2013 (October 10, 2013)
Limiting Liability

- Provision in charter may eliminate personal liability to corporation and shareholders for monetary damages for breach of fiduciary duty as a director.

- Not applicable to:
  - Breach of duty of loyalty
  - Acts not in good faith
  - Unlawful distributions
Limiting Liability

- **Indemnification:**
  - Corporation may indemnify director if he/she acted:
    - In good faith; and
    - In a manner reasonably believed to be in the best interests of the corporation
  - In derivative actions, indemnification generally not permitted if the director is determined to be liable to the corporation
  - No indemnification for Civil Monetary Penalties (CMP)
Limiting Liability

- **Advancement**
  - Corporation may advance fees if director agrees to reimburse the corporation if director is later determined to not be entitled to indemnification.
  - Absolute right to reimbursement of fees if director is successful on the merits with respect to the claim.
Limiting Liability

- D&O Insurance Coverage

  - Types of claims typically covered:
    - Claims for breach of fiduciary duty
    - Claims by employees for discrimination, harassment and other wrongful conduct by directors or officers

  - Types of claims typically not covered:
    - Fraud or dishonesty
    - Intentional wrongful acts
    - Claims among directors
    - Regulatory investigations – Payment of penalties by the Bank are prohibited
Limiting Liability

- D&O Insurance Issues: 12 CFR 359

- 359.01(a): . . . Limits . . . , in certain circumstances, the ability of insured depository institutions . . . to enter into contracts to pay . . . indemnification payments to institution-affiliated parties (IAPs).

- 359.01(c): . . . Generally, this part prohibits insured depository institutions . . . from indemnifying an IAP for that portion of the costs . . . (of an) enforcement action . . . which results in a final order or settlement pursuant to which the IAP is assessed a civil money penalty.
Limiting Liability

- D&O Insurance Issues: 12 CFR 359

- 359.01(c) - Exceptions: First, an institution or holding company may purchase commercial insurance to cover such expenses, except judgments and penalties. Second, the institution or holding company may advance legal and other professional expenses to an IAP directly (except for judgments and penalties) if its board of directors makes certain specific findings and the IAP agrees in writing to reimburse the institution if it is ultimately determined that the IAP violated a law, regulation or other fiduciary duty.
Limiting Liability

- D&O Insurance Issues

- In the past, many insurers provided separate CMP endorsement to Bank’s policy; Bank often charged back cost to directors

- FDIC has recently cited several banks for violations of 12 CFR 359

- Some insurers still offer endorsement; but require that individual directors pay the increased cost out-of-pocket

- Others provide coverage for legal fees but not the penalty itself
Limiting Liability:  FIL 47-2013 (October 10, 2013)

- FDIC noted necessity of providing protections to directors/officers serving financial institutions and use of D&O insurance as a risk mitigation tool
- Noted increase in exclusions from coverage under D&O policies: may result in personal liability
- Directors/officers need to be aware of the extent of coverage and exclusions
Limiting Liability Cont.

- Questions to consider:
  - What protections do I want from my institution’s D&O policy?
  - What exclusions exist in my institution’s D&O policy?
  - Are any of the exclusions new, and if so, how do they change my coverage?
  - What is my potential personal financial exposure arising from each policy exclusion?
  - REMINDER: FDIC regulations prohibit an institution or holding company from purchasing insurance that would be used to pay or reimburse an institution-affiliated party (IAP) for the cost of any civil money penalty (CMP)
  - ALSO – IAP cannot reimburse the institution for the designated cost of the CMP coverage
Common liability scenarios
Securities Offerings

- Many private institutions currently seeking funding
- Private Placement Exemptions
- Anti-Fraud / Disclosure Obligations
Securities offerings

- Rescission Rights

- Ark. Code Annotated 23-42-106(c)

- Purchaser entitled to recover “consideration paid . . . plus interest at 6.00%”

  - Control Person Liability

- Ark. Code Annotated 23-42-106(c)

- “Every . . . officer, or director . . . is jointly and severally liable with the seller”

- No requirement that director or officer “aid in the sale” of the securities.

- Defense: did not know or have reason to know of the violation
How to handle an unsolicited offer to sell

  - If offer is made in apparent good faith, then Directors are required to thoroughly investigate the offer
  - Court said directors must:
    - Seek an independent review of the offer
    - Refrain from conduct designed to thwart the offer
Best Practices
Best Practices

- Focus on Fundamentals  -  Process = Proof
- Dealing with conflicts
- If you have a policy – FOLLOW IT
- Board Meetings:
  - Opportunity for exchange of ideas and thorough discussion
  - Notice / Package to Directors
  - Devote adequate time to significant issues
  - Consider when to call a “Special” meeting
Best Practices

- Minutes of Board Meetings
  - Should be a record evidencing compliance with fiduciary duties
  - Diligence – Debate – Decision
  - Presumption of credibility
  - Anticipate scrutiny
Best Practices *(minutes)*

- What to include?
  - Persons present
  - Begin and end times
  - Information provided to directors prior to the meeting
  - Highlight of presentations to the board
  - Highlight of key issues raised
  - Highlight of deliberation/debate
  - Results of vote taken (or decision not to act)

- Timing of Review

- Personal Notes
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