

Current Topics in Bank Governance and Recommended Practices

by Cam C. Hoang

Banking is one of the most heavily regulated industries in the United States. In recent years, that regulatory burden has grown, as has the complexity of the risks faced by the industry. As a result, it may come as no surprise that it is becoming increasingly difficult for bank boards to continue to be effective.

A multi-year review of bank board practices by the Federal Reserve identified the following challenges:

- Supervisory expectations of boards and senior management have become increasingly difficult to distinguish.
- Boards are often devoting significant time towards satisfying supervisory expectations that do not directly relate to their core responsibilities, which are:
 - Guiding the development of strategy and the types and levels of risk a bank is willing to take;
 - Overseeing senior management and holding them accountable;
 - Supporting the stature and independence of independent risk management and internal audit functions; and
 - Adopting effective governance practices.
- Boards face significant information flow challenges, especially in preparing for and participating in board meetings (and are inherently disadvantaged given their dependence on management for the quality and availability of information).

And the stakes are getting higher for boards. Incoming Federal Reserve Chairman Jerome Powell stated in an August 2017 speech that across a range of responsibilities, the Federal Reserve expects much more of boards of directors than ever before, and there is no reason to expect that to change. In February 2018, the Federal Reserve signed a consent order with Wells Fargo in further response to sales practice issues that were first identified in 2016. The consent order, along with letters sent to the Wells Fargo Board, Lead Director and Chairman, specifically addressed the Board's failure to meet supervisory expectations. In addition to abiding by the terms of the consent order, Wells Fargo will replace four additional members of its 16-member board. Previously, it

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had already replaced half of its board after low shareholder support at its annual shareholder meeting.

In line with the tenor of its communications surrounding the Wells Fargo consent order, in 2017 the Federal Reserve proposed new board effectiveness guidance (FR Doc. 2018–00294). The guidance is expected to be finalized in the first half of 2018 although the Federal Reserve points out that the guidance will consolidate and replace 170 existing board supervisory expectations that currently reside in 27 separate Federal Reserve Board Supervisory and Regulation letters (“SR Letters”).

For large financial institutions with total consolidated assets of \$50 billion or more, the proposal includes specific guidance for board effectiveness, describing the five attributes of effective boards of directors:

- Setting clear direction for the firm;
- Actively managing information and board discussions;
- Holding senior management accountable;
- Supporting independent risk management and internal audit; and
- Maintaining a capable board composition and governance structure.

For financial institutions with consolidated assets of less than \$50 billion, the Federal Reserve plans to review and rescind or revise board expectations that currently reside in 27 SR Letters as well as those found in interagency guidance. It is anticipated that this will result in the consolidation and clarification of board expectations, consistent with and complimentary to the attributes identified for large institutions.

Finally, in order to keep the board properly focused on their core responsibilities, most matters requiring attention (MRAs) and matters requiring immediate attention (MRIAs) will be directed to senior management, instead of the board, for remediation.

As this proposal moves towards adoption, bank directors may need to re-examine their role, as it has been established over time in charter documents, board policies, meeting agendas and governance practices and expectations, and whether their role fulfills the core responsibilities articulated by the Federal Reserve or other regulators. Where the board role has expanded beyond the core responsibilities, and at the expense of fulfilling those responsibilities, a realignment of board versus management roles may be overdue.

The legal obligations for bank directors are complex, because they are governed by a voluminous body of laws and regulations that can vary depending on whether a bank is state or nationally chartered. Fiduciary duties owed by directors in principle are similar to those owed by directors at other companies, including the duty of loyalty, which requires them to put the interests of the company and its stockholders over their own personal interests in making decisions and evaluating opportunities for the company, and the duty of care, which requires them to exercise care in making decisions, on an informed basis and with a good faith belief that their decisions are in the best interest of the company and its stockholders. Regulatory agencies such as the FDIC may have their own articulations of these duties.

The standard for liability for bank directors in case of a bank failure can be found in Section 1821(k) of FIRREA, which stipulates that directors and officers may be personally liable for loss or damage caused by their “gross negligence,” as defined by state law. Under *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599 (Del.Ch. 1974), gross negligence involves a reckless indifference or a deliberate disregard of the interests of the company and its stakeholders, or actions that are not within the bounds of reason. However, a savings clause in section 1821(k) provides that the FDIC may pursue claims based on “simple negligence” (a mere failure to exercise reasonable care) if state law permits liability under a lower standard. See *Atherton v. FDIC*, 519 U.S. 213 (1997).

In fulfilling the duty of care, directors may consider the following guidance:

- **Participate knowledgeably** and conduct a thorough decision making process when evaluating proposed transactions (see below about engaging experts). It is not sufficient for the director to attend meetings or direct the president of the bank to comply with applicable rules and regulations. The director should actively involve his- or herself in understanding the bank's financial condition and important matters;
- **Hold regular board meetings** and ensure that agendas and board materials cover the board's responsibilities, as they are articulated by charter documents and under law;
- **Actively review reports and significant communications from auditors and regulators**, paying particular attention to identified problem areas;
- **Ask questions** that demonstrate a “credible challenge” to management's positions;
- **Ensure minutes** document the information presented to the board and the breadth of the board's deliberations, and that demonstrate a “credible challenge” of management, including questions asked;
- **Engage experts** to advise the company on financing transactions, acquisitions, strategic alternatives and corporate governance, but...
- **Exercise independent judgment.** If a director disagrees with a board action, the director should state his/her view, explain the reasons for disagreement and request that the position be recorded in the minutes;
- **Insist on an adequate written loan policy and investment policy.** A director should carefully review loans recommended by the bank's loan committee to ensure that the loans comply with: (a) the bank's loan policy; (b) sound banking principles; and (c) applicable state and federal statutes. A director should insist that decisions made by the board of directors on loans referred to the board by the loan committee be documented and included in the minutes for that meeting;
- **Supervise management.** A director must see that the management personnel hired by the board of directors pursues the policies directed by the board thoroughly and competently. As stated above, it is not sufficient for the board of directors to hire a president or CEO for a bank and defer all key decisions to that individual; and
- **Wrongful act.** A director must not under any circumstances make a false statement in a report or otherwise about the bank's operations and must bring any issues that involve illegal or negligent conduct on behalf of the bank to his or her fellow directors and the president or chief executive officer. If a matter involving a wrongful or illegal act is brought for vote at a meeting of the board of directors, the director should go on record in opposition to the wrongful activity. In the face of a series of wrongful acts, it may not be sufficient for a director to vote against the wrongful acts or resign from the board of directors, the director may have an obligation to bring a lawsuit seeking to stop the wrongful activity.

In fulfilling the duty of loyalty, directors may consider the following guidance:

- **Disclose potential and actual conflicts of interest** so that the board can determine how to proceed; the director may be asked to recuse him/herself from the deliberations;
- **Conflicts may involve family members, businesses, trusts or other affiliations;** and
- Realize that **controlling shareholder transactions** may be subject to an “entire fairness” standard of review.

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