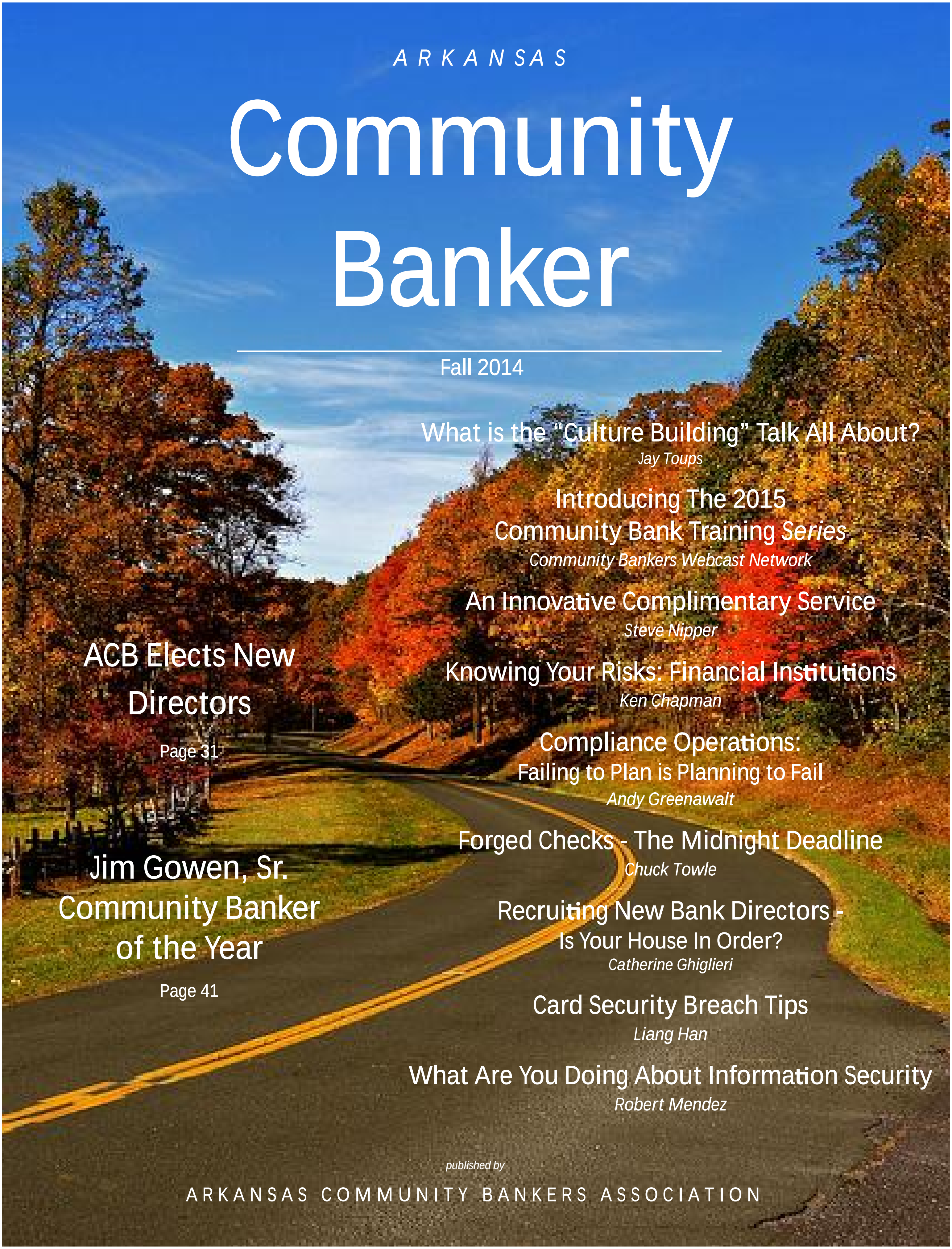

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Civil Monetary Penalties and the Gap in Bank D&O Coverage

While this is not a new issue, the FDIC thought it was important to remind banks in Financial Institution Letter 47-2013 that they cannot indemnify or pay for insurance policies which pay claims for civil monetary penalties assessed against a bank's institution-affiliated parties or "IAPs" (which generally includes officers, directors and controlling shareholders). In the letter the FDIC also made it clear that there is

> *......it is the duty of the board to ensure the safety and soundness of a bank, lax compliance standards and board inactivity can lead to significant monetary penalties*

no exception from this restriction for banks that pay for such insurance, but are reimbursed by the IAP for the policy expense. This had become a common workaround that banks used to provide such coverage for their officers and directors, but it is now clearly prohibited.

Federal regulators have a three tier system to impose CMPs against IAPs. The first tier includes violations of any law or regulation, violations of certain orders, violations of conditions imposed on the bank or IAP by the federal regulator, or violations of any agreement entered into with the federal regulator. The potential liability for a first tier violation is $5,000 each day while the violation continues. The second tier is for any violation in the first tier, recklessly engaging in unsafe and unsound banking practices, or breach of fiduciary duty if such breach is a part of a pattern of misconduct, causes or is likely to cause more than a minimal loss to the bank, or results in a gain to the offending party. The final tier is knowingly committing first tier violations, engaging in unsafe or unsound banking practices, or breaching any fiduciary duty, any of which knowingly or recklessly causes a substantial loss to the bank or gain to the offending party. The fines for the latter two tiers may be up to $25,000 each day during the violation.

First tier violations are the most common because they do not require that the IAP have knowledge or intent, just that the IAP's actions, alone or with others, went towards causing, bringing about, participating in, counseling, or aiding or abetting a violation.

Simply not being diligent in a director's duty to ensure the bank is adopting and enforcing appropriate policies is sufficient to warrant a CMP. *In the Matter of Yessick*, No. 00-050k (FDIC June 3, 2003), the FDIC had warned Cornerstone Community Bank of Chattanooga, Tennessee, and its directors in 1997 that a functioning audit committee was needed. Even though Cornerstone adopted internal audit procedures in 1998, the bank was criticized for not having improved its internal audit functioning. The FDIC noted that management had failed to adequately direct and supervise internal audit controls, and that there was a lack of a written procedures manual for internal audit guidance. During this time, Cornerstone's holding company had become overdrawn on its account with the bank by more than $400,000. The FDIC determined that Cornerstone should have obtained a security and a promissory note for such an extension of credit, and the failure to do so was a violation of sections 23A and 23B. The FDIC fined each of the bank's 14 directors $5,000.

Thirteen of the directors agreed to pay the fine, but one of the outside directors objected. Her defense was that she did not know about the violations until the FDIC examiners pointed it out. She also argued that because she was an outside director she did not routinely see Cornerstone's account and reconciliation statements, so she could not have learned of the overdrafts before they were discovered by the examiners. The FDIC believed she missed the point. Had the directors ensured that proper audit procedures and internal controls were in place, such errors could have been prevented, or at least remedied before they were discovered by the regulators.

Because it is the duty of the board to ensure the safety and soundness of a bank, lax compliance standards and board inactivity can lead to significant monetary penalties. A bank does not need to be distressed financially for a federal regulator to find violations and penalize a bank and its IAPs. Just two years before the directors of Cornerstone were fined, the bank received an overall CAMEL rating of two. If CMPs are levied against IAPs, they may be shocked to discover their D&O policies do not insure against such penalties.

A bank or its holding company may make indemnification payments to an IAP for legal expenses incurred as a result of administrative proceedings or civil actions initiated by a federal banking agency under certain circumstances. However, the board must, in good faith, determine in writing after an investigation that the IAP acted in good faith and in the best interests of the institution, that such payments will not materially adversely affect the institution's safety and soundness, and that the payment does not violate the prohibition against indemnifying an IAP for CMPs. The board must also obtain a legal opinion that they followed these procedures. The IAP must then agree in writing with the board that if the proceedings do result in a CMP, or other violations, the IAP will repay the institution for those indemnification payments.

Directors need to stay active and make sure issues raised by bank regulators are addressed adequately because lack of knowledge will not be an excuse. Increased regulatory burdens and increased complexity within banks create a greater risk that banks will fail some parts of an examination, even if the banks are healthy. Directors must evaluate the risks associated with being a director, recognize which risks are excluded in their D&O policy, and decide whether they need to purchase additional coverage outside of their bank purchased policies.

Daniel J. Beck is an associate of the law firm of Quattlebaum, Grooms & Tull, PLLC, Little Rock, AR. Mr. Beck regularly assists banks with regulatory guidance, corporate governance, loan documentation and capital formation. He has been recognized as a Mid-South Rising Star in the area of Banking by Super Lawyers and may be reached at (501) 379-1762 or dbeck@qgtlaw.com. QGT is an ACB Associate Member.