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Introduction

Recent bank failures[1] and the competitive climate in which banks and other financial institutions operate today[2] make the examination of the liability and responsibilities of directors of state and national banks particularly appropriate. In addition, there is an increasing disparity in the sophistication of management and directors of the respective institutions. While large institutions hire professional directors, many smaller community oriented banks continue to attract directors primarily because of the honor of serving on a bank board. Both professional and honorary directors need to be aware of the liability and potential risk accompanying service on a bank board.[3]

Recently the Federal Deposit Insurance Corporation (FDIC)

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[1] *See generally* McCue, *No Immediate Dropoff in Failure Rate*, Am. Banker, Jan. 6, 1984, at 1, col. 1 (FDIC anticipates that the number of 1984 bank failures will be close to the post-1939 record number that failed in 1983); *Failures Leave Tennessee Banks in State of Flux*, Am. Banker, Jan. 3, 1984, at 1, col. 1 (stating 12 Tennessee banks failed in 1983).

[2] *See, e.g., FDIC Chairman Stresses That New Controls Are Needed for Bank and Thrift Regulation*, [Report Bulletin 20] 21 Control of Banking (P-H) ¶ 20.4 (Mar. 31, 1983) (Chairman William M. Isaacs of the Federal Deposit Insurance Corporation (FDIC) urged the adoption of new controls to "deal with an increasingly deregulated and competitive banking environment.").

[3] *See, e.g.,* First State Bank v. United States, 599 F.2d 558, 562 (3d Cir. 1979) ("[i]f, through recklessness and inattention to the duties confided to him, frauds and misconduct are perpetrated by other officers and agents or codirectors, which ordinary care on his part would have prevented, [a director of a bank] is *personally* liable for the loss resulting.") (emphasis added) (quoting 1 Michie on Banks and Banking 280 (1973)).

announced that more federally insured banks failed in 1983 than in any year since 1939.[4] In 1982 and 1983, an aggregate of ninety federally insured banks failed,[5] including twelve in Tennessee.[6] The number of banks which are characterized by the FDIC as problem institutions[7] has grown from 369 in 1982 to a present figure of 631.[8] Two of the largest bank failures in history occurred during 1983.[9] In addition, federally insured savings and loan associations experienced one of their worst periods since, if not including, the Depression.[10] In fact, the liquidity problems experienced by one California savings and loan were so severe that federal regulatory agencies approved the first acquisition in history of an out-of-state thrift institution[11] by a bank holding company.[12]

Thrift institutions, national banks, state banks, insurance companies and brokerage houses all face substantial changes in the marketplace in which they operate. As a result of federal

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[4] *See* McCue, *supra* note 1, at 19, col. 1 (in 1983, 48 federally insured banks failed, while 60 failed in 1939).

[5] *Id.*

[6] *See Failures Leave Tennessee Banks in State of Flux*, *supra* note 1, at 1, col. 1. One of the 12 which failed was United American Bank of Knoxville which had $590 million in deposits and $791 million in assets, making it the fourth largest bank failure in the history of the FDIC. *Id.* Its failure precipitated the collapse of the banking empires of C.H. and Jake Butcher in Tennessee and Kentucky. On January 6, 1984, Farmers Bank & Trust of Tennessee closed to become the thirteenth such failure in Tennessee since United American Bank of Knoxville closed in 1983.

[7] Problem institutions are banks to which the FDIC has given a rating "of four or five on a scale of one (good condition) to five (poor condition)." McCue, *supra* note 1, at 19, col. 1. A rating of four is assigned to banks with "serious financial and operational weaknesses." *Id.* Banks which have "an extremely high or near-term probability of failure" are given a rating of five. *Id.*

[8] *Id.* This number represents 4.3% of the 14,674 federally insured banks, up from 2.5% in 1982. *Id.*

[9] *See Commercial Bank Failures of 1983*, Am. Banker, Jan. 6, 1984, at 6, col. 1. The Drydock Savings Bank, with assets of $2.5 billion, merged into the Dollar Savings Bank of New York on February 9, 1983. United American Bank of Knoxville closed on February 14, 1983, with deposits of $794 million. *Id.*

[10] *See* McCue, *supra* note 1, at 19, col. 1. In 1983, 52 savings and loan associations insured by the Federal Savings and Loan Insurance Corporation (FSLIC) were closed or merged with other associations. *See id.*

[11] "Thrift institutions" include savings and loan associations, mutual savings banks and credit unions.

[12] *See Citicorp Acquires Fidelity*, N.Y. Times, Sept. 29, 1982, at D1, col. 6. In September 1982, Fidelity Federal Savings and Loan Association of San Francisco was acquired by a subsidiary of Citicorp with the approval of the FSLIC, the Federal Reserve Board and the Federal Home Loan Bank Board. *See id.*

deregulation,[13] banks face increased competition from insurance companies, brokerage houses and similar new entrants into the financial marketplace.[14] Banks and thrift institutions will compete more directly as they acquire businesses in areas which historically have been denied them, including real estate, investment banking, insurance and securities brokerage.[15] In addition, the territorial franchise historically enjoyed by banks and thrift institutions is disappearing as regional and national banking becomes more common.[16] In anticipation of the advent of nationwide banking, major financial institutions are making direct and indirect acquisitions of non-bank financial institutions and are forming *de novo* non-bank enterprises across the country.[17]

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[13] *See, e.g,.* Deposit Insurance Flexibility Act, Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.) This Act removed the interest rate differential between banks and savings and loan associations, authorized insured NOW accounts to allow banks to compete with money market funds, increased lending and borrowing limits for single borrowers, authorized federally chartered "banker's banks," and allowed bank holding companies to engage in the insurance business in limited circumstances. Federal regulatory agencies have also allowed banks to expand into new areas of activity. For example, the Comptroller of the Currency recently allowed a national bank to participate in the placement of real estate equity interests in connection with its loans to owners and developers. *OCC Interpretive Letter*, 22 CONTROL OF BANKING (P-H) ¶ 3999.119 (Sept. 21, 1983).

The Comptroller has also allowed companies in the insurance, real estate and securities industries to acquire "nonbank banks" which are not subject to the Bank Holding Company Act because they do not make commercial loans and/or do not take deposits. *See, e.g.*, [Report Bulletin 12] 22 CONTROL OF BANKING (P-H) ¶ 12.4 (Dec. 8, 1983) (investment company chartered a trust company); [Report Bulletin 11] 22 CONTROL OF BANKING (P-H) ¶ 11.11 (Nov. 23, 1983) (company involved in consumer and real estate finance and insurance converted a subsidiary to a national bank making no commercial loans). The Comptroller imposed a moratorium on such applications beginning April 6, 1983. *See id.* at ¶ 11.1. Bills are currently before Congress that would expand interstate banking and allow bank holding companies or their subsidiaries to deal in a wide variety of financial services, including mutual funds, insurance services, municipal bond underwriting and real estate services. *See* [Report Bulletin 12] 22 CONTROL OF BANKING (P-H) ¶ 12.2 (Dec. 8, 1983); [Report Bulletin 2] 22 CONTROL OF BANKING (P-H) ¶ 2.2 (July 21, 1983).

[14] *See Money, Inc.: Wall Street Mergers May Basically Change U.S. Financial System*, Wall St. J., April 22, 1981, at 1, col. 6.

[15] *See Bank Services Under Review*, N.Y. Times, Aug. 29, 1983, at D2, col. 1; *Fed. To Let Banks Serve as Discount Brokers*, N.Y. Times, Aug. 11, 1983, at D1, col. 1. *See generally Despite Greater Risks, More Banks Turn to Venture Capital Business*, Wall St. J., Nov. 28, 1983, at 33, col. 4 (noting that federal regulators were allowing banks to invest up to five percent in venture-capital subsidies).

[16] *See Quickening Pace of Bank Mergers*, N.Y. Times, Sept. 9, 1983, at D8, col. 4.

[17] *See Out of State Holdings by Banks Concern Fed*, N.Y. Times, June 30, 1982, at D1, col. 1.

These major changes in the competitive environment have occurred despite a period of deep recession and high inflation. In an unprecedented period of economic volatility, commercial and mortgage interest rates over the last five years have fluctuated widely.[18] The Federal Reserve Board has been attempting to bring inflation under control by governing the money supply and the federal funds rate which in turn affect commercial and mortgage loan rates.[19]

In Kentucky, anticipated changes of the laws prohibiting multi-county banking[20] and multi-bank holding companies[21] have resulted in numerous bank acquisitions, as well as the formation of chain bank organizations.[22] The collapse of the Butchers' banking chain and the consequent changes of ownership caused intense activity by the Kentucky Department of Banking, and resulted in the introduction before the 1984 legislature of a multi-county banking bill.[23]

In this rapidly changing, high-risk environment, a bank director must prepare his or her bank to survive and compete. More importantly, the director of a troubled or failed bank must deal with concerned regulators, outraged creditors and stunned shareholders.

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[18] For example, the prime rate fluctuated from 15.25% in January 1980 to 20% in April 1980, 11% in July 1980, 21.5% in December 1980, and 11% in February 1983. *See Have Interest Rates Peaked?*, NEWSWEEK, Jan. 5, 1981, at 45; *How High Will Interest Rates Rise?*, U.S. NEWS & WORLD REP., Aug. 22, 1983, at 64; *Impact of Soaring Interest Rates—What's Ahead*, U.S. NEWS & WORLD REP., Dec. 22, 1980, at 53.

[19] *See* statement of Paul A. Volcker, 69 Fed. Res. Bull. 842, 845 (1983).

[20] *See* KY. REV. STAT. § 287.180 (Cum. Supp. 1982) [hereinafter cited as KRS].

[21] KRS § 287.030(3) (1981).

[22] The Federal Reserve Board defines chain banking as a situation in which an "individual, or group of individuals control two or more banks." For example, a chain bank organization would exist if an individual "owns or controls 25 percent or more of the shares of two or more banks; or otherwise exercises a controlling influence over the management or policies of the bank." *Federal Reserve Board Letter*, 4 FED. BANKING L. REP. (CCH) ¶ 43,061D (Mar. 15, 1983). In a recent order approving the formation of a one bank holding company in Kentucky, the Board stated that the holding company's principal stockholder controlled a chain banking organization due to his ownership of 49% of the voting shares of two other Kentucky one-bank holding companies. Order of the Federal Reserve Board, 69 Fed. Res. Bull. 863 (1983).

[23] Shortly after the collapse of the Butchers' banking chain, Governor Brown appointed a task force chaired by the Kentucky Banking Commissioner to study ways to revamp the state's banking statutes and regulations. The task force recommended passage of a multi-bank holding company bill. *See Task Force Endorses Multibank Proposal*, Courier-Journal, Aug. 19, 1983, at C8, col. 5; *Banking Panel Wraps Up Its Multibank Proposal Package*, Courier-Journal, Aug. 12, 1983, at B6, col. 1.

This Article will examine the responsibility of such directors to the bank's shareholders, regulators and creditors within the context of laws relating primarily to banking.[24] While a bank director will be held to have general knowledge of all banking laws, the remainder of this Article is limited to those areas in which director involvement is believed to be most critical and where violation can result in significant personal liability for the director.[25]

I. THE RESPONSIBILITY OF BANK DIRECTORS

The fundamental responsibility of bank officers and directors is to exercise reasonable care to operate a healthy bank in a sound, safe and legal manner for the benefit of its depositors, shareholders, employees and creditors.[26] This standard is difficult to apply due to the various interpretations regarding what constitutes safe and sound banking practices.[27] Further complicating a proper understanding of the duty owed by bank directors are the differing and sometimes competitive public and private interests affecting banks. Fortunately, directors are not without some guidance to assist them in working through this maze of contradiction.

The responsibility of bank directors can be divided into several major areas: (1) choosing capable management to operate the bank on a day-to-day basis; (2) establishing policies for management to follow which relate to the sound and healthy operation of the bank

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[24] This Article does not deal with areas of the director's liability common to all corporations such as securities regulation, take-overs, shareholder battles and duties of the majority to the minority shareholders. Moreover, the Article does not attempt to provide an all inclusive discourse on the laws of every state which govern the conduct of banks and their business. Nor does the Article address the entire body of federal law and regulations on the subject. The analysis is restricted to those areas which most directly involve the risk of personal civil liability to a director.

[25] Excluded from the discussion are criminal penalties such as 12 U.S.C. § 1818(j) (1982) which provides for a $5,000 fine and/or imprisonment for not more than one year for a director who continues to conduct bank affairs after being suspended by the FDIC. Also excluded from this Article are other civil sanctions which may be assessed by a federal or state bank regulatory agency, including use of letter agreements, issuance of cease and desist orders, suspension or removal from office. *See, e.g.*, 12 U.S.C. § 1818.

[26] *Cf.* Rankin v. Cooper, 149 F. 1010 (W.D. Ark. 1907) (bank directors have the duty to exercise the care of an ordinary, prudent person); Scott's Ex'rs v. Young, 21 S.W.2d 994 (Ky. 1929) (directors who exercise ordinary care are not liable for bank failure).

[27] *Compare* Prudential Trust Co. v. Brown, 171 N.E. 42 (Mass. 1930) *with* Briggs v. Spaulding, 141 U.S. 132 (1891).

and which comply with all federal and state laws and regulations; and (3) establishing review procedures for the appropriate implementation of those policies.[28] In addition, to ensure that its responsibilities have been properly discharged, the board of directors should audit the bank's performance to confirm the accuracy and reliability of management's reports on the condition and operations of the bank.[29] When the directors fail in these tasks, and the bank suffers a loss as a result, directors may be exposed to personal liability for neglect of their common law duties or breach of their statutory duties.[30]

In *Prudential Trust Co. v. Brown*,[31] a 1930 decision by the Massachusetts Supreme Judicial Court, a bank brought suit against its directors for losses the bank sustained during their tenure.[32] The directors were generally inexperienced in banking, with the bank's treasurer being the only experienced officer. The president had little banking experience but was well regarded in the community and owned a substantial portion of the bank's stock.[33]

The state Banking Commissioner conducted four audits of the bank's books and reported to the directors, making severe criticisms in each report.[34] The Commissioner's reports indicated sloppy practices were common, pointed out problem loans and made other criticisms of the operation of the bank.[35] The officers responded to the reports by assuring the directors that the needed corrections had been made, but the directors did not confirm this for themselves.[36]

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[28] Grunewald & Golden, *Bank Director Liability Post-FIRA: How to Avoid It*, 98 BANKING L.J. 412, 414 (1981). *See* Newman, *Reducing the Risk of Bank Director Liability*, 96 BANKING L.J. 418, 429-31 (1979). *Cf.* First State Bank v. United States, 599 F.2d 558 (3d Cir. 1979); W. SCHLICHTING, T. RICE & J. COOPER, BANKING LAW §§ 6.02, 6.04-.05 (1982) [hereinafter cited as BANKING LAW].

[29] *See* Rankin v. Cooper, 149 F. at 1013 ("It is incumbent upon bank directors in the exercise of ordinary prudence, and as a part of their duty of general supervision, to cause an examination of the condition and resources of the bank to be made with reasonable frequency."). *See also* Newman, *supra* note 28, at 430.

[30] *See* First State Bank v. United States, 599 F.2d at 562.

[31] 171 N.E. at 42.

[32] *Id.* at 44.

[33] *Id.* at 46.

[34] *Id.* at 48. The directors had requested the audits. *Id.* at 47.

[35] *Id.* at 48.

[36] *Id.*

The Massachusetts Supreme Judicial Court held that the directors were chargeable with knowledge of the bank's true condition after the Commissioner's second report showed continuing problems with the bank's operations. They were thus negligent in not replacing management or making other independent investigations after receiving the Commissioner's second report.[37] The court also found the directors negligent for allowing excessive loans when the bank's capital was impaired and then paying dividends.[38] As a result of their negligence, the directors were held liable for the dividends which were paid after capital was impaired, for losses on loans in excess of the permitted percentage of capital, for permitting overdrafts, for losses incurred on improvident loans, and for losses on loans made which might have been collected or reduced in size by the exercise of reasonable business judgment in handling and disposing of collateral.[39] In so deciding, the court stated:

> Directors are bound to exercise ordinary prudence and skill to care for and invest the money entrusted to the bank, in accordance with its charter and the governing statutes. They must be animated by the utmost good faith. They hold themselves out as having the superintendance and management of all the concerns of the bank. They thereby engage to conduct its business as men of reasonable ability, necessary intelligence and sound judgment ought to conduct it. They must be diligent in ascertaining and in keeping informed as to the condition of its affairs; they must to a reasonable extent control and supervise its executive officers and agents; they must display understanding and insight proportionate to the particular circumstances under which they act. They need not exhibit greater wisdom and foresight than may be fairly expected of the ordinary man in similar conditions. They invite the confidence of the depositing public and must afford the protection thereby implied. They are not bound to give continuous attention to the business of the bank; they are bound only to be present, so far as rationally practicable, at stated meetings of the board and of its committees. They are not re-

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[37] *Id.* at 50.

[38] *Id.* at 52. It should be noted that the directors were found negligent for paying dividends even though the Banking Commissioner had authorized payment.

[39] *Id.*

> quired to be expert accountants or familiar with the details of bookkeeping or to know everything disclosed by the books of the bank. Having regard to the nature and extent of the affairs of the bank and the customs of banking, directors are justified in commiting the conduct of the main business to officers and subordinates and, in the absence of grounds for distrust, to assume that such persons will be upright in the performance of their duties. They are entitled to rely upon the information and advice given them by executive officers whose probity and competence are not under just suspicion, but they cannot surrender to them the responsibilities resting on directors. . . . They must do something to see that statutes established for the protection of depositors are observed and followed.[40]

II. THE DIRECTORS' ROLE IN BANK MANAGEMENT

A. *Management Selection*

The initial function of the board of directors is the selection of competent, experienced and trustworthy management to oversee the day-to-day operations and performance of the bank.[41] Absent serious problems requiring extraordinary effort and remedial attention to the bank's affairs,[42] the courts have held that directors are not required to devote all of their time to the operation and supervision of the bank. They may delegate day-to-day operational and supervisory duties to properly chosen officers and other employees.[43] Such officers and employees should be competent and

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[40] *Id.* at 44-45.

[41] Newman, *supra* note 28, at 431.

[42] *See* Rankin v. Cooper, 149 F. 1010 (W.D. Ark. 1907) (bank directors held to a higher standard of care after events occurred which should have aroused suspicion). *See also* Ford v. Taylor, 4 S.W.2d 938 (Ark. 1928); Kavanaugh v. Gould, 119 N.E. 237 (N.Y. 1918). *Cf.* Scott's Ex'rs v. Young, 21 S.W.2d 994, 997-98 (Ky. 1919) (directors held not negligent in failing to discover defalcations of a cashier with a trustworthy reputation when hired, and who did not change his modest lifestyle or otherwise create any circumstances which would have put directors on notice of his embezzlement).

[43] *See, e.g.,* Wallace v. Lincoln Sav. Bank, 15 S.W. 448, 454 (Tenn. 1891) ("Bank directors are not expected to give their whole time and attention to the business of the company. The customary method in regard to such associations is that the active management and responsible custody is left to the cashier and other agents selected by the directors for that purpose."). *See also* Briggs v. Spaulding, 141 U.S. 132, 164-65 (1891) (an ill director held able to devote less attention to the bank than healthy directors without becoming negligent in his duty). *Cf.* First State Bank v. Morton, 142 S.W. 694, 697-98 (Ky. 1912)

of sufficient integrity that the directors may reasonably entrust them with the bank's daily operations and control over banks assets.[44] Directors are not insurers,[45] however, and are bound only to use that care which ordinarily prudent and diligent men would exercise under similar circumstances.[46] The directors may rely upon reports and information provided by management until such time as circumstances exist which provide reason to doubt the reliability of the employees.[47]

A careful, thoughtful evaluation of potential bank officers and, in particular, the chief executive is extremely important.[48] Management should have integrity and experience in bank management as well as any additional qualifications which the directors find are necessary or appropriate to ensure competent management and supervision of the bank. However, the job of providing for bank management does not stop simply with the selection of well-qualified individuals; the directors must also monitor and review management's performance.[49]

(president/shareholder who received no salary and was only a figurehead, with someone else acting as the executive officer, was likened to a non-compensated director who is not required to devote his entire time to the business). *But see* Bank of Des Arc v. Moody, 161 S.W. 134, 135 (Ark. 1913) (directors held personally liable to bank stockholders for losses resulting from the directors' failure to control the actions of the bank's cashier). *But c.f.* Mobley v. Faulk, 156 S.E. 40, 41 (Ga. 1930) ("The active management of the bank may be delegated to certain officers authorized to manage its business. The directors, however, must exercise a reasonable supervision over such officers.").

[44] Grunewald & Golden, *supra* note 28, at 415 ("directors should seek to retain individuals who have an in-depth knowledge of banking practices and possess reputations for the highest degree of personal and financial integrity"). *See* Briggs v. Spaulding, 141 U.S. at 136.

[45] Rankin v. Cooper, 149 F. at 1013.

[46] Anderson v. Akers, 7 F. Supp. 924, 928 (W.D. Ky. 1934).

[47] *See* Briggs v. Spaulding, 141 U.S. at 148-49; Rankin v. Cooper, 149 F. at 1013, 1015; Prudential Trust Co. v. Brown, 171 N.E. 42, 50-51 (Mass. 1930).

[48] *Cf.* FDIC v. Boone, 361 F. Supp. 133, 146-64 (W.D. Okla. 1972) (directors who had justifiable confidence in the integrity and ability of the bank president were not liable for losses despite his subsequent fraud).

[49] Grunewald & Golden, *supra* note 28, at 414. *See* Michelsen v. Penney, 135 F.2d 409 (2d Cir. 1943). The court in *Michelsen* stated:

> [A] director conscientiously carrying out the duties of his office cannot be held for statutory violations of which he neither has nor should have knowledge. There the statute is the only measure of responsibility. But where he has substantially abdicated the responsibilities of his office, then the common-law principle—which is in addition to the statutory rules—operates

B. *Monitoring Management's Performance*

The board of directors must know the functions and responsibilities of management, and make sure the selected officers perform their tasks properly.[50] Directors are not relieved of their responsibility to monitor management even though voting control of the bank rests in the hands of the management team rather than with the directors.[51] Directors must also establish policies and procedures to prudently guide management in the bank's operations.[52] Due to the board's continuing responsibility to supervise management, and because it may rely on management's operation of the bank only when such reliance is reasonable,[53] it is imperative that the directors be familiar with the major areas of bank operations and establish guidelines within which management may prudently and effectively exercise its functions.

III. MONITORING THE BANK'S FINANCIAL AFFAIRS

A. *Monitoring Sources of Risk*

The business of a bank is to accept deposits from others and to make such funds, together with its stockholders' capital, available to others at a fee, either as loans or through permitted investments.[54] Major sources of risk such as deposits, investments and loans, should be governed by reasonable policies. A bank's

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> to make him liable for losses improperly incurred by his co-officers to whom he has abandoned the operation of the bank.

Id. at 419.

See also Bank of Commerce v. Goolsby, 196 S.W. 803, 809-11 (Ark. 1917) (directors must give proper supervision to officers); Cunningham v. Shellman, 175 S.W. 1045, 1050 (Ky. 1915) (selection of competent management does not excuse directors from a continuing duty of ordinary care); Medford Trust Co. v. McKnight, 197 N.E. 649, 655 (directors are entitled to rely on trustworthy officers but cannot surrender responsibilities).

[50] *See* Grunewald & Golden, *supra* note 28, at 414; Newman, *supra* note 28, at 429-31.

[51] A number of the cases involving a failure of the directors to monitor management were situations where management owned a substantial, if not controlling, block of stock. *See, e.g.,* Briggs v. Spaulding, 141 U.S. at 157.

[52] *See* First State Bank v. United States, 599 F.2d 558, 564 (3d Cir. 1979); BANKING LAW, *supra* note 28, at § 6.04; Newman, *supra* note 28, at 429-31.

[53] *See, e.g.,* Ringeon v. Albinson, 35 F.2d 753 (D. Minn. 1929); Medford Trust Co. v. McKnight, 197 N.E. 649 (Mass. 1935); Prudential Trust Co. v. Brown, 171 N.E. at 42.

[54] *See* P. HORVITZ, MONETARY POLICY & THE FINANCIAL SYSTEM 32 (4th ed.).

profits and losses are dictated by the spread between its cost of money, in the form of deposits, and its income from using such resources, in the form of investments and loans. Errors which affect the cost of money can generate losses as quickly as errors in investment or loan decisions.

1. *Deposits*

The regulatory agencies are concerned with a bank's liquidity, or the ratio of loans to deposits.[55] An acceptable liquidity ratio is difficult to maintain if a bank's deposit base[56] is subject to sudden and extreme fluctuations, while its loan portfolio remains stable. The FDIC has recognized the dangers in brokered deposits[57] and, with the Federal Home Loan Bank Board, has indicated that all insured banks are currently required to report the amount of brokered funds as part of the bank's quarterly Report of Condition.[58] The board of directors should establish policy guidelines for setting deposit rates, terms and ratios to total assets, bank capital and total loans so that the bank may maintain liquidity, profitability and safety.

2. *Investments*

In addition to deposits, another major source of risk rests in a bank's investment portfolio. Investment losses reduce profits, capital and deposits. The board of directors must ensure that in-

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[55] 12 U.S.C. § 82; KRS § 287.300.

[56] A bank's deposit stability rests in its core deposits—those likely to remain with the bank indefinitely. Other deposits may represent investment funds, usually in the form of large certificates of deposit, seeking high yields but which may not be relied upon by the bank. Such funds may have been bought by the bank from the depositors or intermediary brokers and often prove unreliable, moving quickly from one institution to another seeking better rates. Brokered deposits should not be relied upon by a bank in making loans for terms longer than those represented by the certificates of deposit.

[57] A brokered deposit is obtained through a broker who solicits his customers to make insured deposits in their own or in the broker's name or to buy participations in an insured certificate of deposit. Brokers also operate clearinghouses where investors can obtain information about deposits in various institutions. The FDIC is afraid that these practices enable virtually any institution to attract large volumes of insured deposits regardless of the institution's financial and managerial strength. *See* FDIC Press Release 86-83, [Current Vol.] FED. BANKING L. REP. (CCH) ¶ 99,765 (Oct. 24, 1983).

[58] *Id.*

vestments are carefully chosen as to their rates and safety,[59] monitored for diversity, and matched with the bank's deposit base as to the rates and term. Daily investment decisions can be delegated to reliable employees, but the investment policy of the bank and its methods of monitoring compliance are proper concerns for the board of directors.

3. *Loans*

While both deposits and investments are major sources of risk for a bank, no area of the bank's operation is more fraught with risk than its lending activities. Nonetheless, making loans of bank deposits and capital is the business of a bank. In determining bank directors' negligence, courts are too often concerned with loan losses and institutional insolvency from uncollected loans.[60] However, because of the risk, all facets of the bank's loan activity, including the identity, integrity and financial resources of the borrower, the use to which the funds will be put, the security and the cash flow for the repayment, the rate being charged and the time period for which the funds are committed, are the proper subject of board oversight and policymaking.[61] The directors must be aware of the percentage of the bank's capital and surplus committed to its total loan portfolio as well as that percentage which may be subject to a single risk.[62] The possible effect on the liquidity of the bank's current loans and its loans in default, is a proper concern of the board. Improper attention to the loan portfolio may constitute negligence resulting in personal liability to the director.[63]

Because of the loan portfolio's impact on the stability of a

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[59] *See* Haynes v. Pierce, 6 F. Supp. 403 (W.D. Okla. 1934) (directors held not liable for purchasing illegal municipal bonds where they could not know of the illegality).

[60] *See, e.g.,* Holman v. Cross, 75 F.2d 909 (6th Cir. 1935).

[61] *Cf.* Scott's Ex'rs v. Young, 21 S.W.2d 994, 999 (Ky. 1929) (bank directors who exercise "reasonable care and diligence in looking after the affairs of the bank" are not personally liable for loans exceeding the loan limit when the bank incurs no loss).

[62] For the maximum percentage to be allowed to a single risk in Kentucky, see KRS § 287.280 (1981).

[63] *See generally* Wallace v. Lincoln Sav. Bank, 15 S.W. 448, 453 (Tenn. 1891) ("if [directors] turn over the management of the [bank] to the exclusive control of other agents, thus abdicating their control, then they are guilty of gross neglect" and may be liable for any losses resulting to the bank).

bank, all banks are now subject to statutory lending limits which are enforced by the applicable regulatory authorities.[64] Some of these restrictions apply only to extensions of credit to insiders or affiliates.[65] Other restrictions, such as those found in various state statutes, applicable to state chartered banks,[66] and those found in the National Bank Act of 1864 (NBA),[67] applicable to all nationally chartered banks, place an overall limit on a bank's lending to an individual borrower.

The NBA restricts national banks from lending to any person, co-partnership, association or corporation more than fifteen percent of the aggregate of the bank's unimpaired capital stock and surplus, subject to certain statutory exemptions.[68] Section 93 of the NBA imposes personal liability on directors who knowingly violate, or permit a bank officer or agent, to violate any provision of that Act.[69] Under section 93, a director's liability is predicated on participation and knowledge.[70] Therefore, loans made without the participation or knowledge of a director will not result in personal liability,[71] provided the director has not grossly ignored his duty to investigate.[72]

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[64] *See, e.g.*, KRS § 287.280. A bank's primary regulator is the source of the regulatory framework surrounding its activities. The Office of the Comptroller of the Currency (OCC) is the primary regulator of national banks, while the state department of banking is the primary regulator of state chartered banks. However, the Board of Governors of the Federal Reserve System (FED) also regulates banks which are members of its system (including all national banks), and state nonmember banks are regulated by the FDIC. For a discussion of the state and federal bank regulatory framework, see Scott, *The Patchwork Quilt: State and Federal Roles in Bank Regulation*, 32 STAN. L. REV. 687 (1980).

[65] *See, e.g.*, 12 U.S.C. §§ 84, 375(a)-(b) (1982); KRS § 287.280(2).

[66] *See, e.g.*, KRS § 287.280.

[67] 12 U.S.C. § 84.

[68] *See id.* See 12 C.F.R. § 32 (1983) for interpretive rulings of this section.

[69] 12 U.S.C. § 93(a) (1982) provides:

> If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions of this Title . . . every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person, shall have sustained in consequence of such violation.

[70] *See id.*

[71] *See* Corsicana Nat'l Bank v. Johnson, 251 U.S. 68, 83-84 (1919) (director who knowingly participated in an excessive loan held liable); Holman v. Cross, 75 F.2d at 912 (director is not liable for excessive loan about which he had no knowledge).

[72] *See* Prudential Trust Co. v. Brown, 171 N.E. 42 (Mass. 1930).

Moreover, since a violation of section 84 of the NBA occurs when the total debt exceeds the applicable loan limit,[73] the amount of liability may vary depending upon the facts. Where there are multiple loans, only those disbursements by the bank after the total debt reaches the lending limit (the difference between the greatest amount of the debtor's obligation and the amount outstanding prior to the violation), constitute the loss. In *First National Bank v. Keller*,[74] a series of transactions occurred resulting in an aggregate loan to a corporation in excess of the bank's lending limit.[75] Prior to the loan, which made the aggregate debt exceed the limit of $167,584.20, the corporation owed $156,578.33. After the transaction it owed $219,733.77. The court held the directors liable for the difference between the $219,733.77 and $156,578.33, not the $167,584.20 which was the legal lending limit.[76] On the other hand, where a single transaction exceeds the applicable lending limit, the total amount of the loan is recoverable.[77] In addition to recovery of the loan, liability under section 93 of the NBA can also include damages suffered by the bank, its shareholders or other persons.[78]

Because neither the Federal Reserve Act (FRA)[79] nor the Federal Deposit Insurance Act[80] impose similar limits on normal borrowings, state chartered banks are governed only by the restrictions of their respective state statutes. Restrictions applicable to Kentucky chartered banks are found in KRS section 287.280. This section prohibits a bank or trust company from lending more than twenty percent of its paid-in capital stock and surplus to any person, unless the loan is collateralized or a mortgage in excess of the cash value of the indebtedness is given.[81] Regardless of whether the loan is

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[73] 12 U.S.C. § 84(a)(1).

[74] 318 F. Supp. 339 (N.D. Ill. 1970).

[75] *Id.* at 344.

[76] *Id.* at 347.

[77] *See* Corsicana Nat'l Bank v. Johnson, 251 U.S. at 68, where the Court held that two simultaneous loans could be aggregated and treated as a single transaction which exceeded the applicable lending limit. *Id.* at 80-82.

[78] *See* 12 U.S.C. § 93(a). *See also* First Nat'l Bank v. Hubbard, 240 S.W. 854 (Mo. Ct. App. 1922); City Nat'l Bank v. Crow, 111 P. 210 (Okla. 1910). There is also a concurrent common law liability for making loans negligently. *See* Payne v. Ostrus, 50 F.2d 1039, 1044 (8th Cir. 1931).

[79] 12 U.S.C. §§ 221-522 (1982).

[80] 12 U.S.C. §§ 1811-1832 (1982).

[81] KRS § 287.280(1). For purposes of determining whether a bank has exceeded its

collateralized or a mortgage is given, indebtedness of any person to the bank may not exceed thirty percent of the bank's paid-in capital stock and surplus.[82]

Directors of Kentucky chartered banks which violate or acquiesce in the violation of lending limits can be held individually liable.[83] At least one court has recognized that these limits were designed for the protection of the bank, its creditors (including depositors) and shareholders, all of whom may sue directors to recover in appropriate circumstances.[84]

In order to properly discharge their duties as directors and to avoid liability to shareholders, directors must also be aware of ad-

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lending limit, the liability of individual members of a partnership is included in the aggregate indebtedness of the partnership, and any credit extended "for the benefit of a person, partnership or association shall be included in the total [indebtedness] of the person, partnership or association." *Id.*

[82] KRS § 287.280(3). "Capital stock" is defined at KRS § 287.010(i) (Cum. Supp. 1982) as the sum of:

> 1. The par value of all shares of the corporation having a par value that have been issued; 2. The amount of the consideration received by the corporation for all shares of the corporation that have been issued without par value except such part of the consideration as has been allocated to surplus in a manner permitted by law; and 3. Such amounts not included in paragraphs 1 and 2 of this subsection as have been transferred to stated capital of the corporation, whether through the issuance of stock dividends, resolution of the bank's board of directors under applicable corporate law or otherwise by law.

"Surplus" is defined at KRS § 287.010(j) (Cum. Supp. 1982) as "the amount of consideration received by the corporation for all shares issued without par value that has not been allocated to capital stock or the amount of consideration received by the corporation in excess of par value for all shares with a par value or both." Note that undivided profits and earned surplus are excluded from "paid-in capital stock and surplus."

[83] KRS § 287.990(5) states: "Any directors of a bank who knowingly violate, or knowingly permit any officer or employe of the bank to violate, any of the laws relating to banks, shall be jointly and severally liable to the creditors and stockholders for any loss or damage resulting from such violation." *See* Cunningham v. Shellman, 175 S.W. 1045, 1051 (Ky. 1915) (negligent directors held liable to depositors for losses); Wickliffe v. Turner, 157 S.W. 1125, 1127 (Ky. 1913) (directors held liable for exceeding statutory lending limits). *See also* Scott's Ex'rs v. Young, 21 S.W.2d at 998 (directors were not personally liable since they exercised reasonable care in the management of the bank).

[84] *See* Cunningham v. Shellman, 175 S.W. at 1051. In this case, the directors who were found to be grossly negligent in the management of the bank were held liable for the loss occasioned by loans made in excess of the statutory limit. *Id.* Directors who presumably have exercised due care but have knowingly permitted the 30% limit to be violated may be liable for the amount of the loan which exceeds the limit. In addition, failure to adequately secure a loan which exceeds the 20% limit may subject directors to liability for the entire loan. *See* Wickliffe v. Turner, 157 S.W. at 1127 (single stockholder had a cause of action for such a violation).

ditional restrictions contained in various federal and state statutes. The most significant federal legislation affecting transactions by bank directors and other insiders is the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA).[85] Most of FIRA's provisions apply to all federally insured banks including national banks, state chartered banks which are members of the Federal Reserve System and state chartered nonmember banks insured by the FDIC.[86] Thus, its provisions affect almost every bank and bank director.[87]

B. *Monitoring the Payment of Dividends*

Declaring dividends on the bank's stock is a board function[88] which affects all shareholders and, to the extent it removes resources from the bank, also affects the bank's solvency. Therefore, in some circumstances, payment of dividends can result in personal liability to the director. Paying dividends when capital is, or may be, impaired has been found to be negligent conduct on the part of the directors, giving rise to personal liability.[89] The National Banking Act (NBA) provides for dividends to be declared quarterly, semiannually or annually, at the discretion of the board of directors, and limits the amount of the dividend to the bank's

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[85] Pub. L. No. 95-630, 92 Stat. 3641-3671 (codified in scattered sections of 12 U.S.C.). This legislation was adopted in the wake of much publicity regarding alleged insider abuses of banking institutions. Perhaps the most notorious of these reports concerned the former director of the Federal Office of Management and Budget, Bert Lance. *See* Guenter, *The Lance Legacy—Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978*, 96 BANKING L.J. 292 (1979).

[86] *See* 12 U.S.C. §§ 1971, 1972(2), 1841(c).

[87] For an overview, discussion and analysis of the impact of FIRA on banking, see Grunewald & Golden, *supra* note 28; Geunter, *supra* note 85. For a detailed explanation of FIRA as it relates to correspondents and insider loans see Note, *Correspondent Banking and Insider Loans After the Financial Institutions Regulatory and Interest Rate Control Act of 1978*, 37 WASH. & LEE L. REV. 1327 (1980).

[88] *See* 12 U.S.C. § 60(a) (1982); KRS § 287.350(1) (Cum. Supp. 1982).

[89] *See, e.g.,* Cunningham v. Shellman, 175 S.W. at 1050-51 (the negligent declaration of unlawful dividends when bank was insolvent resulted in the directors being liable for the full amount of losses to depositors regardless of the amount of the dividend). *But see* Scott's Ex'rs v. Young, 21 S.W.2d at 999 (directors were not personally liable since they exercised reasonable care in bank management); Medford Trust Co. v. McKnight, 197 N.E. 649, 669 (Mass. 1935) (directors who relied on the advice of investment committee in deciding to declare a dividend were not negligent in declaring a dividend in excess of the earnings available and thus were not personally liable).

net profits.[90] Other NBA requirements include: (1) the payment of dividends cannot result in impairment of the bank's capital;[91] (2) at the time of payment the bank must not be in default on any payment of any assessment due to the FDIC;[92] and (3) at the time of payment any cumulative dividends on outstanding preferred stock must be fully paid.[93] In addition, until its capital surplus is equal to its capital stock account, prior to declaring a quarterly or semiannual dividend, the bank must add to its surplus at least ten percent of its net profit for the preceding half year, or, in the case of annual dividends, for the preceding two consecutive half years.[94] Regulatory approval is required to declare dividends which exceed a bank's current net profit.[95]

For Kentucky banks, KRS section 287.350 restricts dividends to that portion of the bank's net profit which the board of directors deems to be proper.[96] Both the Kentucky statute and the NBA require that, before a dividend can be declared, at least ten percent of the bank's net profits for the period covered by the dividend must be carried to its surplus account until the surplus equals the common capital stock account.[97] Approval of the Commissioner of Banking is required for dividends in excess of the aggregate of the bank's net profits for the year in which the dividend is declared plus retained net profits from the preceding two years.[98] Payment of illegal dividends by a board of directors may result in personal liability to the directors, and this liability may exceed the amount of the dividend paid.[99]

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[90] *See* 12 U.S.C. § 60(a).

[91] 12 U.S.C. § 56 (1982); 12 C.F.R. § 7.6100 (1983).

[92] 12 U.S.C. § 1828(b) (1982); 12 C.F.R. § 7.6100(c).

[93] 12 U.S.C. § 51b(b) (1982); 12 C.F.R. § 7.6100(c).

[94] 12 U.S.C. § 60(a). In this context "surplus" means paid-in or capital surplus, rather than earned surplus (sometimes referred to as undivided profits). 12 U.S.C. § 51.

[95] 12 U.S.C. § 60(b); 12 C.F.R. § 7.6100(b).

[96] *See* KRS § 287.350(1).

[97] *See* 12 U.S.C. § 60; KRS § 287.350(2).

[98] KRS § 287.350(4).

[99] *See* Roberts v. Hargis, 96 S.W.2d 691, 692 (Ky. 1936) (where directors pay dividends on an insolvent bank or dividends which render the bank insolvent, the commissioner of banking may recover the amount of the dividends from the directors, and the bank's depositors can also recover from the directors the amount of their loss); Cunningham v. Shellman, 175 S.W. at 1051 (directors of an insolvent bank were grossly negligent in declaring dividends and were liable for full amount of debts due the depositors).

C. *Monitoring Management Interlocks*

Directors owe a duty of loyalty to the bank on whose board they serve.[100] This duty requires fairness and caution on the part of directors who serve on the boards of two banks.[101] The Depository Institution Management Interlocks Act (Interlocks Act) now prohibits management officials[102] of one depository institution from serving as management officials of certain other depository institutions.[103]

Depository institutions affected by the above restrictions include banks, savings and loans and credit unions.[104] In order to foster competition, management officials of a depository institution or depository holding company are prohibited from serving in a similar capacity with another institution or holding company if the two organizations "(1) are not affiliated"[105] and "(2) are very

[100] *See* Globe Nat'l Bank v. McLean, 269 P. 9, 11 (Colo. 1928).

[101] *See id.* ("His relation to both banks and their depositors was one of trust, in the discharge of which he is held to the utmost good faith.").

[102] "Management official" is defined in 12 U.S.C. § 3201(4) (1982) as "an employee or officer with management functions, a director (including an advisory or honorary director), a trustee of a business organization under the control of trustees, or any person who has a representative or nominee serving in any such capacity. . . ." The term "management official" specifically excludes: (1) one whose management functions relate exclusively to retail merchandising or manufacturing; (2) one whose management functions relate principally to the business outside the United States of a foreign commercial bank; or (3) other persons specifically excluded from § 202(4) of the statute. *Id. See* 12 C.F.R. § 26.2(h) (1983) (applicable to national banks); 12 C.F.R. § 212.2(h) (1982) (applicable to state member banks); 12 C.F.R. § 348.2(h) (1983) (applicable to state insured nonmember banks).

[103] 12 U.S.C. §§ 3202, 3203 (1982).

[104] 12 U.S.C. § 3201(1).

[105] 12 C.F.R. § 348.1. Interlocking relationships between affiliates are not prohibited by the statute. Institutions are affiliates if: (1) one of the institutions is a subsidiary of the other which is a depository holding company or if both institutions are subsidiaries of the same holding company, incorporating the definition of subsidiary contained in 12 U.S.C. § 1841(d) or 12 U.S.C. § 1730a(a)(1)(H) (1982); (2) the same persons beneficially own more than 50% of the voting stock of each of two institutions; (3) one institution is a mutual savings bank, and all the stock of the other institution which is a trust company is owned by one or more mutual savings banks; or (4) one of the institutions is an insured state bank whose voting securities are held by other banks or officers of other banks and the bank primarily provides services for other banks and not for the public. 12 U.S.C. § 3201(3). Shares belonging to an individual's spouse, parent, child, grandchild, sibling or sibling's spouse are included as shares of the individual, whether or not any of their shares are held in trust. 12 C.F.R. §§ 26.2(b), 212.2(b), 348.2(b). The federal supervisory agency may determine that an asserted affiliation was created to avoid the Interlocks Act prohibitions. If this determination is made, there is no real commonality of interest, and therefore, there

large or are located in the same local area."[106]

Thus, in general, the Interlocks Act's prohibitions apply to depository institutions[107] or depository institution holding companies[108] if: (1) one entity has total assets in excess of one billion dollars and the other has total assets in excess of $500 million;[109] (2) either entity has total assets greater than twenty million dollars and they or their affiliates have offices in the same standard metropolitan statistical area; or (3) neither entity has total assets of more than twenty million dollars and they or any affiliates have offices in the same or any contiguous or adjacent city, town or village.[110]

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is no affiliate relationship based on common ownership. In making this determination, the agencies will consider, among other things, whether a person, together with members of his or her immediate family whose shares are necessary to constitute the group, owns a minimal percentage of the shares of one of the organizations which is substantially disproportionate to the percentage of shares owned in the other organization. 12 C.F.R. § 26.2(b) (applicable to management officials of national banks); 12 C.F.R. § 212.2(b) (applicable to state member banks); 12 C.F.R. § 348.2(b) (applicable to management officials of state insured nonmember banks).

[106] 12 C.F.R. § 348.1(b).

[107] 12 U.S.C. § 3201(1) provides: "[T]he term 'depository institution' means a commercial bank, a savings bank, a trust company, a savings and loan association, a building and loan association, a homestead association, a cooperative bank, an industrial bank, or a credit union. . . ." The term also includes a United States office of a foreign commercial bank. *See* 12 C.F.R. § 26.2(f) (applicable to national banks); 12 C.F.R. § 212.2(f) (applicable to state member banks); 12 C.F.R. § 348.2(f) (applicable to state insured nonmember banks).

[108] 12 U.S.C. § 3201(2) (1982) provides:

> [T]he term "depository holding company" means a bank holding company as defined in Section 2(a) of the Bank Holding Company Act of 1956 [12 U.S.C. § 1841(a)], a company which would be a bank holding company as defined in Section 2(a) of the Bank Holding Company Act of 1956 . . . but for the exemption contained in Section 2(a)(5)(F) . . . thereof, or a savings and loan holding company as defined in Section 408(a)(1)(D) of the National Housing Act [12 U.S.C.§ 1730a(a)(1)(D)].

[109] 12 U.S.C. § 3203 (1982). Note that total assets are "measured on a consolidated basis as of the close of the organization's latest fiscal year." 12 C.F.R. § 26.2(1) (applicable to national banks); 12 C.F.R. § 212.2(1) (applicable to state member banks); 12 C.F.R. § 348.2(1) (applicable to state insured nonmember banks).

[110] 12 U.S.C. §§ 3202-3203. "Office" means a principal or branch office of the depository institution located in the United States, "but does not include a representative office of a foreign commercial bank, an electronic terminal, or a loan production office." 12 C.F.R. § 26.2(i) (applicable to national banks); 12 C.F.R. § 212.2(i) (applicable to state member banks); 12 C.F.R. § 348.2(i) (applicable to state insured nonmember banks). "Adjacent cities, towns or villages means cities, towns or villages whose borders are within ten road miles of each other at their closest points." 12 C.F.R. § 26.2(a) (applicable to na-

D. *Monitoring Insider Transactions*

Banking transactions that involve insiders have been the subject of recent legislation which attempts to curb insider abuses.[111] According to a congressional report:

> Self-dealing is involved in almost all serious problem bank situations. It is generally found in form of an over extension of credit on an unsound basis to large share owners, or their interests, who have improperly used their positions as owners to take money from the bank in the form of unjustified loans (or sometimes as fees, salaries, or payments for goods or service). Active oficers who hold their positions at the pleasure of the board and share owners are subject to influence and therefore are not usually in a position to evaluate and reject these credits on the same basis as the credit requests of other bank customers. In a situation of this nature, active management will often vigorously defend the unsound loans or other self-dealing practices perpetrated upon the bank by the owners.[112]

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tional banks); 12 C.F.R. § 212.2(a) (applicable to state member banks); 12 C.F.R. § 348.2(a) (applicable to state insured nonmember banks). Specifically exempted by the terms of 12 U.S.C. § 3204 are:

> (1) A depository institution or depository holding company which has been placed formally in liquidation, or which is in the hands of receiver, conservator or other official exercising a similar function; (2) A corporation operating under Section 25 or 25(a) of the Federal Reserve Act ["Edge corporations"]; (3) A credit union being served by a management official of another credit union; (4) A depository institution or depository holding company which does not do business within any state of the United States . . . except as an incident to its activities outside the United States; (5) A state-chartered savings and loan guaranty corporation; or (6) Federal Home Loan Bank or any other bank organized specifically to serve depository institutions.

12 U.S.C. § 3204 (1982).

Other interlocking relationships may be permitted by the Comptroller if: (1) one of the organizations is located in a low income or other economically depressed area or is controlled or managed by persons who are members of minority groups or by women; (2) one of the organizations is a newly chartered organization; (3) one of the organizations faces conditions endangering the organization's safety or soundness; (4) one of the organizations is a federally insured credit union that is sponsored by the other depository organization or its affiliate primarily to serve employees of that depository organization; or (5) if an organization is likely to lose 50 percent or more of its directors or of its total management officials due to a change in circumstances. 12 C.F.R. § 26.4(b) (applicable to national banks); 12 C.F.R. § 212.4(b) (applicable to state member banks); 12 C.F.R. § 348.4(b) (applicable to state insured nonmember banks).

[111] *See, e.g.*, 12 U.S.C. §§ 375a-375b (1982).

[112] H.R. REP. No. 1383, 95th Cong., 2d Sess. 10 (1978). For a general discussion of

Principal sections of FIRA[113] restricting insider loans are found in sections 22(g) and 22(h) of the Federal Reserve Act[114] which applies to national banks and state member banks. Federally insured nonmember banks are also subject to section 22(h).[115] The Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the FDIC have all adopted regulations regarding insider loans.[116] Section 22(h) contains four general rules. First, the statute sets maximum limits on loans to executive officers,[117] principal shareholders[118] and their related interests[119] equal to the

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the restrictions of FIRA on insider loans, see Note, *Insider Loans: How Restricted is the Banker?*, 9 FORDHAM URB. L.J. 431 (1980-81).

[113] *See* note 85 *supra*.

[114] 12 U.S.C. §§ 375a-375b.

[115] While the statute refers to "member banks" it has been made applicable to federally insured nonmember banks by the Federal Deposit Insurance Act. 12 U.S.C. § 1828(j)(2) (1982).

[116] The Federal Reserve Board has adopted regulations interpreting both sections 22(g) and 22(h) in Regulation O. 12 C.F.R. § 215 (1982). The Comptroller has adopted, by reference, the loan limits set forth in Regulation O as the loan limits for national banks. 47 Fed. Reg. 49,347 (1982) (to be codified at 12 C.F.R. § 31.2). The FDIC has issued regulations which make substantially all of Regulation O, except those provisions interpreting Section 22(g) (relating to restrictions on loans to executive officers), applicable to state insured nonmember banks. 12 C.F.R. § 337.3(a)-(b) (1983) (as amended by 48 Fed. Reg. 42,969 (1983) (to be codified at 12 C.F.R. § 337.3(b))).

[117] An executive officer is defined as:

> A person who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions of the company or bank, whether or not: (1) The officer has an official title, (2) the title designates the officer an assistant, or (3) the officer is serving without salary or other compensation. The chairman of the board, the president, every vice president, the cashier, the secretary, and the treasurer of a company or bank are considered executive officers, unless (1) the officer is excluded, by resolution of the board of directors or by the bylaws of the bank or company, from participation . . . in major policymaking functions of the bank or company, and (2) the officer does not actually participate therein.

12 C.F.R. § 215.2(d) (1983).

[118] For purposes of applying the maximum lending limit, the term "principal shareholder" is defined differently when the bank is located in a low population density area. If the bank is located in a city with a population of less than 30,000, a shareholder must have the power to vote more than 18% of any class of voting securities of the bank before being deemed a principal shareholder. In other instances, a principal shareholder is one who holds more than 10% of any class of a bank's voting securities. 12 U.S.C. § 375(b)(1) (1982). Note that for purposes of the second and third general rules set forth in the text, the separate definition for banks located in small towns or cities is not applicable. *See id.*

[119] A "related interest" means "(1) a company that is controlled by a person or (2) a political or campaign committee that is controlled by a person or the funds or services

limits on loans to a single borrower established by 12 U.S.C. § 84.[120] Section 84 provides that total unsecured loans to any one person shall not exceed fifteen percent of the aggregate unimpaired capital and surplus of the bank,[121] plus an additional ten percent of its aggregate unimpaired capital and surplus if the loan is secured by readily marketable collateral having a market value at least equal to the amount of the loan.[122]

Section 22(h) also requires that all loans to executive officers, directors, principal shareholders[123] or related interests which exceed amounts established by regulation of the appropriate federal

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of which will benefit a person." 12 C.F.R. § 215.2(k) (1982). A person "controls" a company if that person directly or indirectly, acting through or in concert with others,

> (A) owns, controls, or has power to vote 25 percentum or more of any class of voting securities of the company; (B) controls in any manner the election of a majority of the directors of the company; or (C) has the power to exercise a controlling influence over the management or policies of such company.

12 U.S.C. § 375b(5) (1982).

A person is presumed to have control, including the power to exercise a controlling influence over the management or policies of a company or bank if:

> (i) The person is (A) an executive officer or director of the company or bank and (B) directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; or (ii)(A) the person directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank, and (B) no other person owns, controls, or has the power to vote a greater percentage of that class of voting securities.

12 C.F.R. § 215.2(b)(2). "An individual is not considered to have control . . . of a company or bank solely by virtue of the individual's position as an officer or director of the company or bank." 12 C.F.R. § 215.2(b)(3). A person who is presumed to have control may rebut the presumption by submitting to the appropriate federal banking agency written materials that demonstrate a lack of control. 12 C.F.R. § 215.2(b)(4).

[120] 12 U.S.C. § 375b(1) (1982).

[121] *See* 48 Fed. Reg. 42,805 (1983) (to be codified at 12 C.F.R. § 215.2(f)). A bank's unimpaired capital and surplus equals the sum of:

> (1) the "total equity capital" of the member bank reported on its most recent consolidated report of condition . . . , (2) any subordinated notes and debentures approved as an addition to the member bank's capital structure by the appropriate Federal banking agency, and (3) any valuation reserves created by charges to the member bank's income.

Id.

[122] *Id.* The market value must be based upon "reliable and continuously available market price quotations." *Id.*

[123] The definition of principal shareholder, which triggers board approval and nonpreferential treatment under § 22(h), is one who holds more than 10% of any class of the bank's voting securities. 12 C.F.R. § 215.2(j). The more liberal "small-town" definition applies only to the lending limits of 12 U.S.C. § 375b(1).

banking agency, be approved in advance by a majority of the board of directors, with any interested party abstaining from participating directly or indirectly in the voting.[124] The Federal Reserve Board, Comptroller and FDIC have adopted regulations which set the threshold for board approval at the aggregate, when considered with all other loans to that person or to any related interest, of more than $25,000, or five percent of the bank's capital and surplus, whichever is higher.[125] Regardless of the size of the bank, all loans to insiders which in the aggregate exceed $500,000 require prior approval of the bank's board of directors.[126]

All insider loans must also be made on substantially the same terms, including interest rates and collateral, as those prevailing for comparable transactions and must not involve more than the normal risk of repayment.[127] A bank also may not pay an overdraft on the account at that bank of an executive officer or director.[128]

Section 22(g)[129] of the Federal Reserve Act prohibits member banks from extending credit to executive officers[130] unless the ex-

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[124] 12 U.S.C. § 375b(2).

[125] *See* 48 Fed. Reg. 42,804 (1983) (to be codified at 12 C.F.R. § 215.4(b)) (Federal Reserve Board); 48 Fed. Reg. 42,969 (1983) (to be codified at 12 C.F.R. § 337.3(b)) (FDIC); 48 Fed. Reg. 44,062 (1983) (to be codified at 12 C.F.R. § 31.2(b)) (Comptroller).

[126] 48 Fed. Reg. 42,804 (to be codified at 12 C.F.R. § 215.4(b)) (applicable to state member banks); 48 Fed. Reg. 42,969 (to be codified at 12 C.F.R. § 337.3(b)) (applicable to state insured nonmember banks); 48 Fed. Reg. 44,062 (to be codified at 12 C.F.R. § 31.2(b)) (applicable to national banks).

[127] 12 U.S.C. § 375b(3).

[128] 12 U.S.C. § 375b(4). For a detailed discussion of the prohibition against overdrafts, see text accompanying notes 159-61 *infra*.

[129] 12 U.S.C. § 375a.

[130] For purposes of § 22(g), "an executive officer of a member bank does not include an executive officer of a bank holding company of which the member bank is a subsidiary or any other subsidiary of that bank holding company." 12 C.F.R. § 215.5(a) n.4. A bank cannot extend credit to a partnership in which one or more of its executive officers are partners with a majority interest, either individually or together, unless the aggregate loan meets the limitations noted in the text accompanying notes 125-26 *supra* and note 133 *infra*. 12 C.F.R. § 215.5(b). In determining the limitations on other loans, the full amount of any credit extended to a partnership is deemed to have been extended to each executive officer of the bank who is a member of the partnership. *Id.* Note also that loans to related interests of executive officers (other than partnerships) are not subject to the restrictions of § 22(g). However, such loans are covered by the lending limits and other requirements of § 22(h). *See* 12 U.S.C. § 375b.

tention of credit is a mortgage loan,[131] a loan to finance the education of the executive officer's children,[132] or a general extension of credit which does not exceed the higher of $25,000 or 2.5 percent of the bank's capital and unimpaired surplus, but in no event more than $100,000.[133] Any extension of credit by a member bank to any of its executive officers must be reported promptly to the member bank's board of directors. The extension of credit must be on substantially the same terms, including interest rates and collateral, as those terms prevailing at the time for comparable transactions by the bank with other persons, and must not involve more than the normal risk of repayment or present other unfavorable features.[134] In addition, the extension of credit may be made only after the executive officer has submitted a detailed current financial statement, and the credit extension must be contingent on a stipulation that the bank has an option to make the extension due and payable if the officer borrows from any other bank making his total debt equal to either 2.5 percent of the bank's capital or $25,000, whichever is greater. In any event, the total debt incurred may not exceed $100,000.[135]

A member bank must attach to its report of condition to the FDIC a list of all extensions of credit made by the member bank to its executive officers since the date of the bank's previous report of condition.[136] Also, after Dec. 31, 1983, each member bank and each state insured nonmember bank must, upon written request from the public, make available the names of its executive officers and principal shareholders (and their related interests) to whom it had credits outstanding of more than $25,000, if the aggregate

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[131] Mortgage loans may be made to an executive officer provided the loan is specifically approved by the bank's board of directors prior to granting the loan, is "secured by a first lien on a dwelling which is expected to be owned by the officer and to be used by him as his residence," and "no other loan by the bank to the officer under the authority of [§ 22(g)] is outstanding." 12 U.S.C. § 375a(2).

[132] 12 U.S.C. § 375a(3). *See also* 47 Fed. Reg. 49,347 (1983) (to be codified at 12 C.F.R. § 215.5(c)(1)).

[133] 48 Fed. Reg. 42,804 (1983) (to be codified at 12 C.F.R. § 215.5(c)(3)) (applicable to state member banks); 48 Fed. Reg. 44,062 (1983) (to be codified at 12 C.F.R. § 31.2(a)) (applicable to national banks).

[134] 12 C.F.R. § 215.9(d).

[135] *Id.*

[136] 12 C.F.R. § 215.9 (1983).

credit equaled or exceeded the lesser of five percent or more of the bank's capital and surplus or $500,000.[137]

Further, section 22(d) of the FRA prohibits any member bank from selling to or acquiring securities or other property from any of its directors or their related interests unless the sale or purchase is made in the regular course of business upon terms not less favorable to the bank than those offered to others, or the sale or purchase is authorized by a disinterested majority of the board of directors.[138] Also, section 22(e) prohibits a member bank from paying preferential interest rates on deposits by directors and other insiders.[139]

A civil penalty of up to $1,000 for each day a violation continues may be assessed against any director "participating in the conduct of the affairs" of a bank which violates any provision of section 22.[140] In determining the amount of the penalty, the applicable banking authority considers the size of financial resources, the good faith of the person charged, the gravity of the violation, any previous violations and "such other matters as justice may require."[141]

In addition, the FRA expressly provides for a private right of action.[142] A director "participating in or assenting to [a violation of section 22] shall be held liable in his personal and individual capacity for all damages which the member bank, its shareholders,

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[137] 48 Fed. Reg. 56,934 (1983) (to be codified at 12 C.F.R. § 215.10(b)) (applicable to member banks); 48 Fed. Reg. 57,110 (1983) (to be codified at 12 C.F.R. § 349.4(a)) (applicable to state insured nonmember banks). Member banks must maintain records of all requests and their subsequent disposition. 48 Fed. Reg. 56,934 (to be codified at 12 C.F.R. § 215.10(c)). State insured nonmember banks must maintain copies of the requests and record the bank's disposition of them. 48 Fed. Reg. 57,110 (to be codified at 12 C.F.R. § 349.4(c)).

[138] 12 U.S.C. § 375.

[139] 12 U.S.C. § 376.

[140] 12 U.S.C. § 504 (applicable to member banks); 12 U.S.C. § 1828(j)(3) (applicable to state insured nonmember banks). Penalties assessed pursuant to 12 U.S.C. § 504 and 12 U.S.C. § 1828(j)(3) require a lesser standard of culpability than the private right of action created by 12 U.S.C. § 503. These sections require only that the director participate in the conduct of the affairs of a bank which violates any provision of § 22. There is no knowledge requirement. Grunewald & Golden, *supra* note 28, at 426.

[141] 12 U.S.C. § 504 (applicable to member banks), 12 U.S.C. § 1828(j)(3) (applicable to state insured nonmember banks).

[142] *See* 12 U.S.C. § 503.

or any other persons shall have sustained in consequence of such violation."[143]

Kentucky banks are also restricted in extending credit to directors or officers.[144] The applicable statute states:

> No bank or trust company shall permit any of its directors or officers to become indebted or obligated as guarantor or surety to it in an amount exceeding 10% of its capital stock actually paid in, without securing the excess by the mortgage or pledge of real or personal property double in value the amount of the excess.[145]

Even if adequately collateralized, the total debt of a director or officer to his bank may never exceed thirty percent of its paid-in capital and surplus.[146]

E. *Monitoring Transactions with Affiliates*[147]

Section 23A of the FRA[148] governs certain financial transactions between banks and their affiliates.[149] Section 23A prohibits a bank from entering into certain transactions[150] with affiliates[151]

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[143] *Id.* The statute requires that the director "knowingly violate or permit" the violation of the provisions of § 22. *See id.*

[144] *See* KRS § 287.280(2).

[145] *Id.* Note that the benchmark for maximum debt to directors and officers is 10% of capital stock actually paid in, and does not include the bank's surplus. *Cf.* KRS § 287.280(1), (3) (lending limitations are expressed in percentages of paid-in capital and actual surplus).

[146] KRS § 287.280(3).

[147] For a detailed discussion of the statutory restrictions on transactions with affiliates authored by staff members of the Federal Reserve Board, see Rose & Talley, *Bank Transactions with Affiliates: The New Section 23A*, 100 BANKING L.J. 423 (1983).

[148] 12 U.S.C. § 371c (1982).

[149] Section 23A imposes limitations on member banks. Its provisions also apply to insured nonmember banks under 12 U.S.C. § 1828(j)(1).

[150] Covered transactions include:

> (A) a loan or extension of credit to the affiliate; (B) a purchase of or an investment in securities issued by the affiliate; (C) a purchase of assets . . . from an affiliate, [unless the assets are] specifically exempted by the Board by order or regulation; (D) the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit to any person or company; or (E) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or stand by letter of credit, on behalf of an affiliate.

12 U.S.C. § 371c(b)(7).

[151] The term "affiliate" includes: (1) the parent holding company of the bank and

unless: (1) the transaction is an exempt transaction;[152] (2) the loan is properly collateralized;[153] (3) the aggregate amount of the covered

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any sister company controlled by the parent bank holding company; (2) any bank subsidiary of the bank; (3) any company controlled by the same persons controlling the bank, or in which a majority of its directors constitutes a majority of directors in the bank or any company that controls the bank; (4) any company "sponsored and advised on a contractual basis" by the bank or any affiliate of the bank, or an investment company with respect to which the bank or any affiliate is an investment advisor; and (5) any company which is determined by the Federal Reserve Board to have a relationship with the member bank or its subsidiary or affiliate so that a covered transaction between the bank and the company may be affected by the relationship, to the detriment of the bank. 12 U.S.C. § 371c(b)(1) (1982). Specifically excluded from the definition of an affiliate are:

> (A) any company, other than a bank, that is a subsidiary of a member bank . . . ; (B) any company engaged solely in holding the premises of a member bank; (C) any company engaged solely in conducting a safe deposit business; (D) any company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and (E) any company where control results from the exercise of rights arising out of a bona fide debt previously contracted. . . .

12 U.S.C. § 371c(b)(2).

[152] The following transactions are specifically exempted from the provisions of section 23A:

> (1) any transaction, [other than the purchase of low quality assets (unless the bank or affiliate, pursuant to an independent credit evaluation committed itself to purchase the asset prior to the time the asset was purchased by the affiliate), between 80% or more owned sister bank subsidiaries in a multi-bank holding company organization]; (2) making deposits in an affiliated bank . . . in the ordinary course of correspondent business . . . ; (3) giving immediate credit to an affiliate for uncollected items received in the ordinary course of business; (4) making a loan or extension of credit to, or issuing a guarantee acceptance or letter of credit on behalf of, an affiliate that is fully secured by—
>
> > (A) obligations of the United States or its agencies, (B) obligations fully guaranteed by the United States or its agencies as to principal and interest; or (C) a segregated, earmarked deposit account with the member bank;
>
> (5) purchasing securities issued by any company described in section [4(c)(1) of the Bank Holding Company Act of 1956]; (6) purchasing assets having a readily identifiable and publicly available market quotation and purchased at the market quotation . . . ; or (7) purchasing from an affiliate a loan or extension of credit that was initiated by the member bank and sold to the affiliate subject to a repurchasing agreement or with recourse.

12 U.S.C. § 371c(d).

In addition, the Federal Reserve Board may issue regulations and orders to exempt any other transaction or relationship if it is "in the public interest and consistent with the purposes of this section." 12 U.S.C. § 371c(e).

[153] The collateral must have a market value at the time of the transaction equal to 100-130% of the amount of the loan, depending on the type of collateral. 12 U.S.C. §

transactions to that affiliate does not exceed ten percent of the capital and surplus of the bank;[154] and (4) the aggregate of all covered transactions to all affiliates does not exceed twenty percent of the capital and surplus of the bank.[155] Section 23A also prohibits a bank from acquiring a "low-quality asset"[156] from an affiliate unless, pursuant to an independent credit evaluation, the acquiring bank commmitted to purchase the asset prior to the asset's acquisition by the affiliate.[157] For each day a violation of section 23A continues, the applicable federal regulatory agency can assess a civil penalty of up to $1,000 per day against a director participating in the affairs of the violating bank.[158]

F. *Monitoring Overdrafts*

Under FIRA, a bank may not pay an overdraft on an executive officer's or director's account,[159] unless it does so in accordance with a written, pre-authorized interest bearing credit plan which includes a repayment plan, or under a written, pre-authorized transfer from another account of the same person at the bank.[160]

371c(c)(1). Collateral which is subsequently retired or amortized must be replaced by additional eligible collateral, where needed, to keep the collateral value equal to the minimum percentage required for the remainder of the loan. 12 U.S.C. § 371c(c)(2). Low quality assets and securities issued by affiliates of the bank are not acceptable collateral. 12 U.S.C. § 371c(c)(3)-(4).

[154] 12 U.S.C. § 371c(a)(1)(A).

[155] 12 U.S.C. § 371c(a)(1)(B).

[156] A "low-quality asset" is defined as:

> (A) as asset classified as "substandard," "doubtful," or "loss" or treated as "other loans especially mentioned" in the most recent report of examination . . . prepared by either a Federal or State supervisory agency; (B) an asset in nonaccrual status; (C) an asset on which principal or interest payments are more than thirty days past due; or (D) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.

12 U.S.C. § 371c(b)(10).

[157] *See* 12 U.S.C. § 371c(a)(3).

[158] 12 U.S.C. § 504 (applicable to member banks); 12 U.S.C. § 1828(j)(3) (applicable to state insured nonmember banks).

[159] 12 U.S.C. § 375(b)(4).

[160] 12 C.F.R. § 215.4(d). A bank can also pay "inadvertent" overdrafts if the overdraft being paid, together with any other overdrafts then outstanding, does not exceed $1,000, the overdrafts are not outstanding for more than five business days, and the bank charges the executive officer or director its regular fee for paying overdrafts. *Id.*

The prohibition against paying overdrafts does not apply to one who is only a principal shareholder, nor does it apply to related interests of an executive officer, director or principal shareholder.[161]

G. *Monitoring Transactions with Correspondent Banks*

Under FIRA, banks with correspondent account relationships[162] cannot extend credit to each other's insiders[163] on preferential terms.[164] In addition to the lending restrictions, a bank may not establish a correspondent relationship with another bank if either currently has preferential loans to the other's insiders.[165]

On or before Jan. 31 of each year, executive officers and principal shareholders[166] of every bank must provide a written report[167]

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[161] 12 C.F.R. § 215.4(d) n.3.

[162] Correspondent accounts are those maintained by one bank with another for the deposit or placement of funds. 12 C.F.R. § 215.21(c) (1983). Specifically excluded from the definition of a correspondent account are "(1) Time deposits at prevailing market rates, and (2) An account maintained in the ordinary course of business solely for the purpose of effecting federal funds transactions at prevailing market rates or making Eurodollar placements at prevailing market rates." *Id.* (applicable to member banks); 48 Fed. Reg. 57,110 (1983) (to be codified at 12 C.F.R. § 349.2(d)) (applicable to state insured nonmember banks).

[163] The statute prohibits extensions of credit to executive officers, directors or shareholders having the power to vote more than 10% of any class of voting securities or to any related interest of such shareholder. 12 U.S.C. § 1972(2)(A) (1982).

[164] 12 U.S.C. § 1972(2)(A), (C) (1982). Specifically, the statute prohibits an extension of credit unless it is "made on substantially the same terms, including interest rates and collateral as those prevailing at the time for comparable transactions with other persons and does not involve more than the normal risk of repayment or present other unfavorable features." 12 U.S.C. § 1972(2)(A).

[165] 12 U.S.C. § 1972(2)(B), (D) (1982).

[166] A principal shareholder is "any person . . . that directly, or indirectly, owns, controls, or has power to vote more than 10 percent of any class of the voting securities of the member bank. The term includes a person that controls a principal shareholder (e.g., a person that controls a bank holding company)." 12 C.F.R. § 215.10(a)(2) (1982) (applicable to member banks). *See also* 48 Fed. Reg. 57,110 (to be codified at 12 C.F.R. § 349.2(h)) (applicable to state insured nonmember banks).

[167] The report must include the maximum amount of indebtedness of the executive officer or principal shareholder and each of that person's related interests to each of the bank's correspondent banks during the calendar year, the amount of such indebtedness outstanding to each of the bank's correspondent banks not more than ten business days before the report required is filed, and a description of the terms and conditions (including the range of interest rates, the original amount and date, maturity date, payment terms, security, if any, and any other unusual terms and conditions) of each extension of credit included in the reported indebtedness. 12 U.S.C. § 1972(2)(G)(i). *See also* 12 C.F.R. §

to their bank of any extension of credit[168] from any correspondent bank[169] they or any of their related interests have had outstanding during the previous calendar year.[170] Each bank must advise every principal shareholder and executive officer of the required report and of the name and address of each of its correspondent banks.[171]

H. *Monitoring the Conduct of Non-Directors*

Not only may there be statutory liability to participating directors for violation of the above statutes, but directors may also be liable for negligence in not preventing such violations by others on behalf of the bank.[172] Therefore, it is incumbent upon the directors to include all such matters in the bank's established policies and to install reasonable procedures to ensure that the policies are followed.

215.22(b) (applicable to member banks); 48 Fed. Reg. 57,110 (to be codified at 12 C.F.R. § 349.3(b)(3)) (applicable to state insured nonmember banks).

[168] Extensions of credit which do not have to be reported include "(i) [c]ommercial paper, bonds and debentures issued in the ordinary course of business, and (ii) consumer credit . . . in an aggregate amount of $5,000 or less . . . provided the indebtedness is incurred under terms that are not more favorable than those offered to the general public." 12 C.F.R. § 215.22(c) (applicable to member banks); 48 Fed. Reg. 57,110 (to be codified at 12 C.F.R. § 349.2(f)) (applicable to state insured nonmember banks).

[169] A correspondent bank is defined as

> a bank that maintains one or more correspondent accounts for a member bank during a calendar year that in the aggregate exceed an average daily balance during that year of $100,000 or .05 percent of such member bank's total deposits (as reported in its first consolidated report of condition during that calendar year), which ever amount is smaller.

12 C.F.R. § 215.21(d) (1983) (applicable to member banks); 48 Fed. Reg. 57,110 (to be codified at 12 C.F.R. § 349.2(e)) (applicable to state insured nonmember banks).

[170] 12 C.F.R. § 215.22 (applicable to member banks); 48 Fed. Reg. 57,110 (applicable to state insured nonmember banks).

[171] 12 C.F.R. § 215.22(e); 48 Fed. Reg. 57,110.

[172] *See, e.g.,* Gerner v. Mosher, 78 N.W. 384, 387 (Neb. 1899) (a private individual was granted relief as to director defendants for common law deceit in making false reports to the Comptroller of the Currency). *See also* Briggs v. Spaulding, 141 U.S. at 132 (action was brought for directors' breach of their fiduciary duties as well as for their breach of the federal banking laws); Hoehn v. Crews, 44 F.2d 665, 672 (10th Cir. 1944) (directors supervising the liquidation of a bank have both a statutory and a common law liability in the discharge of their duties); Hughes v. Reed, 46 F.2d 435, 439 (10th Cir. 1931) ("Specific" duties placed upon bank directors by statute do not "relieve such directors from the common law duty to be honest and diligent"); Gamble v. Brown, 29 F.2d 366, 370 (4th Cir. 1928) (the duties imposed on bank directors by the NBA exist in conjunction with the common law duty of ordinary care), *cert. denied*, 279 U.S. 839 (1928).

IV. THE DUTY OF DIRECTORS TO INVESTIGATE

It may not be enough to establish policies and rely on management's reports as to compliance. Directors have a duty to make sure management complies with established policies and must investigate management's actions, taking remedial steps where necessary.[173] Generally, noncompliance can be discovered by periodic outside examinations. Such examinations have proven to be an effective defense to allegations of negligence.[174] While all banks are now under periodic examination by their respective regulatory agencies, it would be unwise to rely upon such examiners to report irregularities to the board of directors.[175] The courts have held that such examinations are for purposes other than helping directors properly manage and oversee the bank.[176] Thus, it would be advisable for the board to retain skilled outside accounting firms to perform periodic audits on the bank and render financial and management performance reports to the board. Moreover, such reports should not be under management's control,[177] but should be controlled by an audit committee of the directors,[178] whose membership changes periodically.

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[173] *See* FDIC v. Mason, 115 F.2d 548, 550-51 (3d Cir. 1940) (bank directors held liable for not hiring an auditor after becoming aware of accounting deficiency); Ringeon v. Albinson, 35 F.2d 753, 754-55 (D. Minn. 1929) (directors liable for failing to act upon learning of officers' imprudent extension of excessive loans); Prudential Trust Co. v. Brown, 171 N.E. 42, 44-45 (Mass. 1930) (directors ignored evidence of bank mismanagement and breached the duty of their office).

[174] *See* Cory Mann George Corp. v. Old, 23 F.2d 803, 807-08 (4th Cir. 1928) (court exonerated the directors of negligence in not discovering embezzlement where the directors audited the accounts of the suspect cashier twice and had independent audits performed by certified public accountants annually); Scott's Ex'rs v. Young, 21 S.W.2d at 997 (directors were not negligent where directors and the state banking examiners regularly examined the bank without discovering the defalcations leading to loss).

[175] *See* First State Bank v. United States, 599 F.2d at 562-63 (bank sued the FDIC because its examiners failed to advise the bank's board of wrongdoing by its president for one year after uncovering such activities); Harmsen v. Smith, 586 F.2d 156, 157 (9th Cir. 1978) (failure of the audit by the Comptroller of the Currency led the bank's directors to sue the Comptroller for negligence).

[176] *See* First State Bank v. United States, 599 F.2d at 563; Harmsen v. Smith, 586 F.2d at 157.

[177] *See, e.g.,* Prudential Trust Co. v. Brown, 171 N.E. at 50 (management did not submit a bank examiner's audit to the board of directors although it contained serious criticisms of the bank operations).

[178] *See* Gamble v. Brown, 29 F.2d at 371 (directors held negligent for not appointing an audit committee "to exercise a supervision of the business, and to examine . . . the af-

CONCLUSION

If bank directors familiarize themselves with the basic banking laws, employ managers who are capable of doing the same, establish policies which give reasonable guidelines to management, establish procedures under which management will effectively report to the board, require periodic third party outside audits to confirm compliance with policy and procedures, and confirm assets and liabilities, they can maintain peace of mind and a fair degree of assurance that their individual assets will be reasonably protected from the claims of the depositors, shareholders, creditors and regulatory agencies who deal with the bank. However, directors should remember that the common law still requires the exercise of ordinary care, diligence and prudence. As the financial industry changes, so will the problems and risks with which a bank must deal, and new duties may be forthcoming. For instance, long-range planning may well be prudent for all banks in this changing environment. Therefore, the position of bank director can no longer be merely an honorary title, but must be accepted as a challenge requiring constant exercise of good business judgment, integrity and intelligence. Directors must be willing to work with bank management to achieve success for the bank while maintaining the reasonable detachment necessary to evaluate management's operation of the bank. The proper discharge of the function of a director, while not quite reaching the difficulty and scope of the Twelve Tasks of Hercules, certainly compares with the cleaning of the Augean stables.

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fairs of the bank . . . and to report the result of their examination in writing to the board"). *See also* Prudential Trust Co. v. Brown, 171 N.E. at 50 (directors are chargeable with the knowledge a competent and disinterested audit would have revealed).