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Accept a bank board seat? A verdict from the litigators

When and why bank directors are most often at risk of civil liability.

By Dennis Klein, Derick Sohn, and Tyler Grove

Our experience litigating the civil liability of former directors of failed banks reveals that, absent conflicts of interest, most bank directors accused of negligence, gross negligence, and/or breaches of fiduciary duty have simply failed to act in one way or another, particularly in response to information indicative of potentially fatal risks. Any individual considering service on a bank board should be sure to understand the attendant obligations before accepting a position as a director. Below we discuss two of the basic — along with some not so obvious — obligations every bank director should know.

1. Supervising the bank's management

As with all corporations, a bank's board of directors is ultimately responsible for overseeing the management of the corporation. A director cannot simply be a rubber stamp. While a director is generally entitled to rely on the representations of management, a director must always exercise his or her own independent business judgment. A director that blindly defers to the judgment of management can be found liable for abdicating his or her supervisory responsibilities over the bank.

In the banking context, it is particularly important that a bank director actively oversee the loan underwriting and administration procedures of the bank. This area is almost invariably central to a bank's success or failure, and bank directors should accordingly be alert to any signs of weaknesses or excessive risks. Federal regulators, for example, expect the board to review and approve the written loan policy at least annually. The prudent bank director will recognize that he may be held liable even for loans that he does not personally approve, if the director in question permitted obviously deficient loan underwriting or administration practices to persist after he became (or should have become) aware of their existence.

In our experience, bank directors are most often at risk of civil liability when they allow themselves to be dominated by an aggressive and/or successful CEO or president, particularly when that individual is also a large shareholder of the bank. A bank director must actively challenge management decisions if circumstances warrant. The fact that a certain management team has been historically successful will not excuse a director's failure to act in the face of information indicative of excessive, systemic risk to the bank.

Relatedly, bank directors should pay careful attention to the compensation of its management and lenders. The nature of banking is such that even recklessly liberal lending can be profitable in the short term but render the bank deceptively fragile in the face of an economic downturn. Compensation packages that exclusively or primarily reward immediate loan production without regard for quality can be viewed as indicative of a disregard for credit risk.

2. Approving loans on an informed basis

The directorial role in approving loans, in contrast, is unique to banks. In most banks, at least some directors are typically required to approve particularly large loans. And as relevant here, the vast majority of cases brought by the FDIC in the recent banking crisis involve allegations that directors negligently or grossly negligently approved loans.

A director's duty in approving a loan is the same as in any other business transaction: the director must review and independently evaluate all reasonably available material information. Before personally approving any loan, a director should require a thorough underwriting analysis. She must be confident that she understands the financial position of the proposed borrower, as reflected in tax returns and financial statements. She should also understand the primary and secondary repayment sources for the loan, as well as any collateral.

A director's duty is not satisfied simply by collecting information, but requires independent consideration. In particular, a director should be alert for any inconsistencies or other "red flags" in an underwriting analysis. Directors should be particularly careful when dealing with borrowers such as real estate developers, who are likely to have numerous extensive credit relationships with other banks. Such borrowers frequently carry contingent and other potentially hidden liabilities; directors should be sure that such relationships were adequately investigated. Directors should also be careful of excessive concentrations of credits in single individuals or industries, and lend more cautiously as such concentrations grow.

It is particularly critical that directors be broadly familiar with the bank's written loan policy. Although a director need not memorize the policy verbatim, he or she should be familiar with basic threshold requirements such as minimum credit scores for borrowers. Further, directors should refrain from granting exceptions to any loan policies too liberally, as routine deviations from written loan policies can be viewed as evidence of disregard for risk.

Finally, directors also owe a duty of loyalty when approving loans, which requires the board to place the interests of the bank above their own interests. A director should therefore refrain from personally evaluating and voting on any loan that may benefit him or herself.

Be an active overseer

Service on a bank board of directors can be a rewarding experience, but is not without its unique risks. Directors who are informed and active in overseeing a bank are much less likely to find themselves at the head of failing or failed banks and, accordingly, less likely to be targeted for civil liability by banking regulators — and less likely to be found liable if targeted.

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