

# Invited to join a bank board?

*There are compelling reasons to accept . . . but careful consideration is required.*

**BY CHARLES J. THAYER**

**I**n many respects the banking industry has become the favorite ‘piñata’ of politicians, the media and the public; everyone feels entitled to take a swipe. The recent financial crisis seriously damaged the image of the entire banking industry, including the reputations of both bankers and bank directors.

Today over 5,000 regional and community banks serve customers and communities throughout our nation. These banks not only survived the crisis but the vast majority remained profitable and they continue to serve their communities through difficult times. All financial institutions may have been painted with the ‘Wall Street’ brush by the media, but most community banks remain on solid footing and continue to work to support economic growth in their communities.

Serving as a board member of a community bank may have been considered an honor in the

past — but times have changed. Accepting such a position today requires careful consideration. This article will explore some of the many pros and cons of serving on a bank board.

I believe the most significant challenge faced by banking today is attracting talented people to such an unpopular industry. Bank directors serve an important and unique role and it is especially important that community banks attract and retain talented people on their boards. Hopefully, the guidance that follows will help you decide if you should be one of those people.

## Quality leadership needed

The banking system provides the financial liquidity required to support our nation’s economic and job growth. Some politicians don’t seem to understand that our nation’s banks provide the oil for our nation’s economic engine and without oil an engine won’t run. As a result, it is essential that the banking industry attract and retain quality leadership in both day-to-day management and in the boardroom.

Community banks have a special relationship with ‘small business,’ and economic analysis in-



**Charles J. Thayer** is chairman and managing partner of Chartwell Capital Ltd., a private investment firm that provides specialized advisory services on a wide range of financial and governance issues to the boards of directors and executive management of banks, corporations and institutional investors ([www.chartwellcapital.com](http://www.chartwellcapital.com)). He organized Chartwell Capital in 1990 following a 20-year career in the banking industry. He is a bank director and currently serves as chairman emeritus of the American Association of Bank Directors. He is the author of *It Is What It Is* (2010), a book describing how the board, management team and employees of AmericanWest Bank successfully navigated their way through the financial crisis of 2008. He can be contacted at [cjt@chartwellcapital.com](mailto:cjt@chartwellcapital.com).

dicates that the majority of job growth is provided by small business. Community banks are best positioned to serve the financial needs of small business and are an essential contributor to future job growth throughout our nation.

The job of a community bank director comes with many risks and few personal rewards. Although this article will first address some of ugly aspects of serving as a bank director, I believe it is a very worthwhile and rewarding position. I am privileged to serve on the board of a Midwest institution with banking locations in four states, and have previously served on the boards of three other banking institutions of varying sizes. My background also includes service as a financial executive at two regional banking institutions and additional board service at two nonfinancial companies. This article addresses the key elements of my decision process before I accepted each of these bank board positions and also before I declined invitations to join a few other bank boards.

Despite the risks I will describe, I encourage you to serve on a bank board that will benefit from your personal knowledge and skill set and that meets your personal due diligence requirements.

### Over 800 rules

The American Association of Bank Directors [AABD] has recently updated an analysis that indicates over 800 bank regulatory rules and regulations apply to bank directors. Bank regulators have continually added new items to the job description of a bank director. The job of a bank director continues to become more complex, with an increasing number of banking rules and regulations to consider in addition to the traditional fiduciary responsibilities required of all corporate directors.

Doing your personal due-diligence and gaining an understanding of the scope of regulatory requirements will help avoid surprises as you engage in bank board activities. Oversight of regulatory compliance is an essential part of a bank director's job but it is also a potential distraction to board oversight of corporate strategy and financial performance. As a result, bank boards tend to meet much more frequently than nonfinancial boards, so be prepared for a substantial time commitment.

Your increased time commitment will not be offset by higher director compensation, as national studies continue to report that community bank directors tend to be compensated at lower levels than board members of nonfinan-

cial corporations of similar size. Don't expect to receive any significant compensation for your time commitment.

Also, expect your attorney to tell you this increased time commitment will be accompanied by more personal liability than board members of nonfinancial corporations due to a bank director's higher regulatory exposure. As a result, you will want to make certain the bank has a robust Directors & Officers insurance policy to protect you as much as possible.

### Loan approvals? No

In addition, you will see media reports about the Federal Deposit Insurance Corporation (FDIC) taking legal action to recover losses from bank officers and directors at failed banks. In my experience, such claims are generally made against

**THE MOST SIGNIFICANT CHALLENGE FACED BY BANKING TODAY IS ATTRACTING TALENTED PEOPLE TO SUCH AN UNPOPULAR INDUSTRY.**

## Bank Board Due Diligence

- **Financial Performance:** Have you reviewed management reports and audit?
- **Management Strategy:** How does management intend to grow?
- **Board Composition and Skill Sets:** Who is on the board and what do they do?
- **Board and Committee Structure:** How does the board and its committees function?
- **Regulatory Requirements:** Do you understand what bank regulators expect?
- **Board Liability and Coverage:** Have you reviewed the D&O policy and bylaw indemnification provisions?
- **People Assessment:** Do you have confidence in the team?
- **Self Evaluation:** Are you the right fit?

— Charles Thayer

board members because they approved loans that ultimately went bad. Therefore, I suggest you and other board members do not approve individual loans (except those required by bank regulation).

Make certain you fully understand how the bank's board and its committee structure functions by reading the bank's committee charters and talking to current board members. However, the most important element of your due-diligence is to gain confidence in the ability and integrity of the bank's board members and management team. We all know that people are the key element that will make or break any business. Take the time to personally evaluate the other board members and gain an understanding of the management team's strategy and abilities.

Your decision to be a bank director also requires some self-evaluation. A successful bank requires a quality mix of people and talent. Can you truly add value to the bank's board, or do

you duplicate existing skills? In my experience effective boards tend to be small, with eight to 12 members and every seat is important. Consider that you might not be the right person to occupy a seat even though the other board members may want you to join. This self-evaluation needs to be an ongoing process and you should also be prepared to recognize when it is time for you to leave the board.

Accept the board seat only after you are comfortable with your duties as a bank director, the time commitment, the board structure, and you have confidence in both the other board members and the management team. Over time you will be building personal and professional relationships with all of these people and they are the key to the bank's future success.

### Unique insight and impact

Once on board the challenge of being a bank director will begin. No other business interacts with every other type of business in the com-

## Joining a bank board? Get radically objective

*Bank board composition tends to be long on street savvy but short on requisite regulatory acumen . . . and, leadership matters!*

### By Mike Kipp

Some 15 years ago, I accepted an invitation to the board of American Home Bank (AHB). As an organizer, I joined a small group making a modest investment in an idea that became the employer of more than 300 people with 1,200 dependents in service of 10,000 customers enjoying nearly a billion dollars in loans. Chartered one month before 9/11, we navigated the sea-

state changes in the industry for nearly a decade. With accelerated capital requirements, our growth stalled. After months of wrestling with alternative scenarios, we elected to sell to a larger bank-holding company.

More recently, I was asked to join the bank of a "troubled institution." The formal agreement required Atlas Bank to elect an outside director with experience in the industry. As the proverbial 'one-eyed man,' I won the raffle. Far from having engaged in risky business, Atlas's troubles stemmed from its commitment to an ethnic, working class population in Brooklyn. Having served its neighbors well for nearly a century as an association, a credit union, state chartered bank, and an S&L, it couldn't meet the more exacting standards of Dodd-Frank and the Office of the Comptroller of the Currency

(OCC). Top-quartile operating ratios, strong capitalization, and a consistently performing loan portfolio proved insufficient to avoid a costly and painful program of remediation and the resulting hit to earnings. As with AHB, the painful but prudent course was to sell to a larger player who would sustain the commitment to the community, the depositors, and most of the employees.

There are many lessons to be drawn from such experiences. Four, though, seem especially relevant for those who've been asked to join a bank board:

1. You are being invited to govern in a greatly consolidating industry. We've gone from 18,000 to just over 5,000 banks since the early 1990s. Some observers say we could get down below 1,000. At one bank for each 50,000 Americans, we're five times the

Get or keep a good CEO. If you have grave misgivings, make the tough call.

munities served by your bank. Bank directors have a unique window into economic activity within their regional and local markets. Your bank's customer and credit strategy will have a direct impact on the lives and jobs of people throughout your markets.

Rapidly developing technology is changing the way banks deliver services and how customers interact with their bank. Competition is no longer local; national institutions can reach into any market with acquisitions and technology. I believe board understanding of this changing, competitive environment is more challenging than the evolving regulatory environment.

Banking is a very dynamic business, and successful banks require boards and management teams with a wide range of knowledge and skills to successfully address changing conditions. Many banks faced with increasing competition and higher costs due to increased regulatory requirements will elect to be acquired. Other bankers will see an opportunity to be an ac-

quirer and grow. Bank boards will constantly be faced with very challenging strategic decisions that will impact shareholders, customers, employees and their communities.

To serve as a member of a community bank board offers you a unique opportunity to provide your insight and personal skills to an institution that is an essential ingredient to the economic health of your community. If you are up to the task, the opportunity to see your bank, its employees, its shareholders, and your community prosper will be your most significant personal reward. ■

**EVERY SEAT IS IMPORTANT. CONSIDER THAT YOU MIGHT NOT BE THE RIGHT PERSON TO OCCUPY A SEAT EVEN THOUGH THE OTHER BOARD MEMBERS MAY WANT YOU TO JOIN.**

banks-per-capita as the U.K. and more than ten times that of our other economic peers around the globe. So forget the rescue fantasy; get radically objective. The right side to be on is the one that preserves value for investors, security for employees, and safety for and soundness for depositors.

2. Bank board composition tends to be long on street savvy but short on requisite acumen in the credit instruments that opened the Dodd-Frank era and the compliance requirements that followed. Both are Achilles heels for these institutions: complex, replete with unintended consequences and costly to remediate. Members owe it to one another to educate themselves on these very real risks. Inertia is a powerful force, though. The new member must be ready to exercise influence without authority in raising the bar. Interview the legacy directors; get a feel for their relative strengths and contributions. Look at some minutes and a few call reports; read the most recent OCC exam.

3. Compliance matters are the fastest

way to rob a bank of its resources and its capacity to bargain for a preferred future. More than 500 remain on the "troubled" list, down from nearly 900 after the "crash" of '08, but it's still a bunch. Smaller banks are disadvantaged with respect to their operating costs, particularly in compliance. This structural disadvantage will become even more pronounced as they make the technology investments required to defend against identity theft. And just complying won't get it; documentation is the coin of the realm. It's like awarding the bass fishing contest to the guy with the neatest tackle box, but there it is: write it down.

4. As in any other operating environment, leadership matters. Governance is an expression of ownership, not some higher order of management. Get or keep a good CEO and craft a supportive agenda. Avoid the temptation to overreach. Remember: the board has one employee; the CEO has all the rest. And if you have grave misgivings, make the tough call. In the words of Martin Landau, no stranger to "impossible missions": "90% of directing is casting."

*Mike Kipp was an organizer and director of American Home Bank, chairman of Atlas Bank, and a board member of several other enterprises. He can be contacted at [mike@kippassoc.com](mailto:mike@kippassoc.com).*



# 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.

*Dennis Klein is a partner with the law firm Hughes Hubbard whose practice focuses on complex commercial litigation, including officer and director liability lawsuits and bank insolvency problems. Derick Sohn and Tyler Grove are associates with the firm in its litigation department. The authors wish to thank Eleanor Erney and Iain Barr for their help in researching this article. The authors can be contacted at klein@hugheshubbard.com, sohn@hugheshubbard.com, and grove@hugheshubbard.com.*