Approved: 3-23-93
Date

MINUTES OF THE HOUSE COMMITTEE ON JUDICIARY

The meeting was called to order by Chairman, Representative Michael R. O' Neal at 3:30 p.m. on March 16, 1993 in room 313-S of the Statehouse.

All members were present except:

Representative Tom Bradley - Excused
Representative Joan Wagnon - Excused

Committee staff present:

Jerry Donaldson, Legislative Research
Jill Wolters, Revisor of Statutes
Cindy Wulfkuhle, Committee Secretary

Conferees appearing before the Committee:

John Wine, General Counsel, Secretary of State's Office
Jim Maag, Kansas Bankers Association
Jeff Sonnich, Kansas Nebraska League of Savings Institutions
Jerel Wright, Kansas Credit Union Association
Bill Sampson, Kansas Association of Defense Counsel
Nick Daley, Kansas Association of Defense Counsel
Ron Smith, Kansas Bar Association
T.C. Anderson, Kansas Society of CPA's
Bill Martin, Smith City State Bank & Trust

Hearings on SB 108 were opened dealing with amendments to the Kansas Limited Liability Company Act.

John Wine, General Counsel, Secretary of State's Office, appeared before the committee as a proponent of the bill. He gave the committee background information that Kansas became the fourth state to adopt a limited liability company act, and that there are currently 18 states that have the act. Sections 1,4, 6,7 & 8, of the handout, are clean-up of 1991 legislation. Section 9 deals with fax filing. Sections 2,3 &4 improve the distributions and liabilities to third parties. (Attachment #1)

Chairman O'Neal questioned if there were any substantive changes.

Wine stated that sections 2,3 & 5 change the way distributions can be made.

Hearings on SB 108 were closed.

Hearings on SB 125 were opened regarding the liability of officers and directors of certain financial institutions.

Jim Maag, Kansas Bankers Association, appeared before the committee in support of the bill. He stated that this is one of the most important issues regarding Banking and Industry, in terms of establishing what the standard of liability for breach of duty of care would be in any banks by outside directors. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 established a uniform gross negligence standard. A recent decision in the case of FDIC v. Canfield, however, contains language suggesting that if a state has not established a gross negligence standard for these situations then the regulators may be able to go after the director or officer on a simple negligence basis. Kansas has never established such a standard and therefore SB 125 is an attempt to bring uniformity and equality as to what standards must be met in suits filed under the federal act. As of now, national banks are held to one standard and state banks are held to another. He stated that a more important issue is being able to attract and retain qualified individuals to serve as directors. He also recommended that the committee remove the amendment (except for the stricken language) that was added by the Senate Judiciary Committee in order to create a uniform negligence standard for both officers and directors. (Attachment #2)

Chairman O'Neal suggested that any state that has not addressed this issue, will now because of the Canfield decision. Maag agreed.

Maag commented that Oklahoma passed legislation in 1992, which contains a procedural retroactivity provision. The proposed bill does not have a procedural retroactive provision in it.

Jeff Sonnich, Kansas-Nebraska League of Savings, appeared before the committee in support of the bill. They agree with the recommendation of Kansas Bankers Association to remove the Senate Judiciary Committee amendment except for the stricken language. They do not support avoidance of fiduciary responsibility and they support the prosecution of fraud. They feel it is important that Kansas define liability statutes to protect officers and directors of financial institutions. (Attachment #3)

Representative Garner asked if other states have attached the retroactivity provision to their legislation and, if so, how was the legislation drafted.

Sonnich stated that Oklahoma has retroactivity language in their statute and Texas has a bill before their legislature that addresses retroactivity. Committee members were advised that the Oklahoma & Texas language appears in the KADC handout.

Jerel Wright, Kansas Credit Union Association, appeared before the committee in support of the bill. They support the effort to codify and clarify the liability of directors for breach of fiduciary duties as directors of Kansas credit unions. The bill establishes the standard under which a director may be held liable for actions or failure to act. (Attachment #4)

Bill Sampson & Nick Daley, Kansas Association of Defense Counsel, appeared before the committee in support of the bill. Bill Sampson briefed the committee regarding the background of RTC and OTS litigation. He described their tactics which involved threatening each and every officer and director with financial ruin and then shaking as much money out of them as possible in settlement. They are able to do this because uncertainty over the existing standard of care makes it impossible for anyone to escape without having to spend thousands and thousands of dollars in defense costs. The RTC is always looking for a "deep pocket" where in virtually every case the officers and directors are community leaders with integrity and the best interest of depositors at heart. The irony of all this litigation is the fact that tax policies passed by congress in the mid 80's is in large part responsible for the failure of some of the institutions' investments; in other words, what were good investments before the tax changes became bad investments afterwards and now the government is trying to recoup losses from innocent directors and officers.

While the Federal Act 12 U.S.C. 1821(k) speaks of a "gross negligence" standard, there is later language in the act suggest that states may have different standards. The laws are not clear in Kansas regarding those standards, and therefore, it is necessary for this legislature to clarify the standard and to make it clear that Kansas adopts the standard in the federal law. Otherwise, the RTC may attempt to hold Kansas' directors and officers to a "simple negligence" standard, where such is not the federal legislative intent.

To that end the KADC proposed an amendment to the bill that would make the language applicable to all actions filed pursuant to l2 U.S.C. 1821(k) regardless of the date of filing. The committee was briefed on legislation passed or pending in other states of a similar nature. Without the proposed amendment, it would be possible that the courts may have to apply different standards

Minutes of the House Committee on Judiciary, Room 313-S, Statehouse, at 3:30 p.m. on March 16, 1993.

to conduct that occurred during the same period of time and, therefore, the amendment should be considered procedural, and/or remedial in nature to clarify the law and prevent the application of inconsistent standards to conduct occurring during the same time frame.

Nick Daily also appearing in behalf of the Kansas Association of Defense Counsel, spoke to the committee in greater detail regarding the KADC proposed amendment and similar legislation in other states. Chairman O'Neal questioned what his feelings were on the Oklahoma language that was tied directly to the effective date of the federal act. Daily stated that the Oklahoma and Texas approaches are good ideas, although he preferred, of the two, the Texas approach.

Chairman O'Neal stated that the committee would most likely want to amend the bill to make it apply procedurally to all actions filed under the federal statute and that the bill would probably be considered in Conference Committee. Proponents were encouraged to continue reviewing proposed language and be prepared to recommend to the Conference Committee the best language to accomplish the task of making the standards consistent in actions filed under the federal act. (Attachment #5)

Hearings on SB 125 were closed.

Hearings on SB 355 were opened regarding professional responsibility of CPA's in providing professional services to financial institutions.

Ron Smith, Kansas Bar Association, appeared before the committee in support of the bill. He stated this bill deals with a narrow range of litigation where the FDIC has taken over the operation of a financial institution and sues to recover funds for alleged mismanagement of the institution. It does not affect the liability of lawyers or CPA's who are bank employees. This bill attempts to keep the FDIC & RTC from alleging a higher standard of care which lawyers and CPAs are supposed to meet when they do not know at the time they undertake the representation what the higher standard will be. (Attachment #6)

T.C. Anderson, Kansas Society of CPA's, appeared before the committee in support of the bill. He stated that this proposed bill would prevent the holding of CPAs performing accounting, auditing, consulting and other services to financial institutions doing business in Kansas to a greater duty of professional responsibility than required by their own professional standards. He also had a proposed amendment which would add language that states "This act is declaratory of and codifies existing Kansas law and policy. This act shall apply to all past, present and future claims or causes of action based on Kansas state law seeking to recover money damages from any person or entity covered within the scope of Section 1 which are filed in any court of competent jurisdiction." (Attachment #7)

Hearings on SB 355 were closed.

Hearings on SB 121 were opened regarding standards for trust investments by fiduciaries.

Bill Martin, Smith City State Bank & Trust, appeared before the committee in support of the bill. He stated that this proposed bill is based on the Prudent Investor Rule as developed by the America Law Institute. This bill does not depart very much from current law, but affords greater flexibility in making investment decisions to enhance yield and value for the benefit of clients of a Kansas fiduciary. (Attachment #8)

Representative Pauls asked if the committee could be provided with a statement from Judicial Council regarding their reaction to the proposed language regarding the power of a court to change trust provisions.

Hearings on SB 121 were closed.

The Committee adjourned at 5:15 p.m. The next Committee meeting is March 17, 1993 at 3:30 p.m. in room 313-S.

GUEST LIST

HOUSE JUDICIARY COMMITTEE

DATE MARCH 16, 1993

NAME	ADDRESS	ORGANIZATION
Cameron Brewer	Topeka	KTLA
Bill Sampson	Lawrence	KADC
Nick Daily	Wichita	KADC
Jeff Sonnich	Topeka	KNLSI
Gerald L. Goodell	Topeka	KNLSI
Charles N. Henson	Topeka	KBA
Kathy Taylor	"	"
Jerel Wright	Topeka	Ks CU Assn
William Q. Martin	Smith Center	Kansas Bankers Assoc.

Bill Graves
Secretary of State

2nd Floor, State Capitol
Topeka, KS 66612-1594
(913) 296-2236

STATE OF KANSAS

TESTIMONY BEFORE THE HOUSE JUDICIARY COMMITTEE
Senate Bill No. 108

March 16, 1993

The office of the Secretary of State supports SB 108 and encourages this committee to favorably recommend it for passage. It passed the Senate by a vote of 40 - 0.

In 1990, Kansas became the fourth state to adopt a limited liability company act. In 1991, several refinements and improvements were made to the act by the Legislature. This bill contains suggestions for further improvements made by members of an informal committee of fourteen attorneys and certified public accountants who work with these business entities.

§ 1 • The first section makes a technical correction by deleting the word "corporate."

§ 2 • Section two clarifies the authority of members and managers to act on behalf of the company.

§ 3 • This section describes default rules for distributions made to members of the company.

§ 4 • Section four would delete the requirement that articles be amended when capital is withdrawn. The articles no longer contain this information.

§ 5 • The rights of creditors of the company are clarified in section five.

HOUSE JUDICIARY
Attachment #1
03-16-93

§ 6 • This section provides that only the organizer of the company needs to sign the articles. The 1991 amendments attempted to authorize this practice but this statutory provision was overlooked.

§ 7 • If a foreign company is managed by managers rather than the members, this section would permit it to list the managers on its application instead of its members.

§ 8 • Section eight clarifies that a certificate of merger should be filed when a merger, authorized by the 1991 amendments, occurs.

§ 9 • The final section gives limited liability companies the opportunity to file documents by FAX. This provision would give companies the same privilege that corporations have used successfully since 1990.

Again, the office of the Secretary of State encourages this committee to favorably report SB 108 for passage.

Thank you.

John Wine, General Counsel

L. L. C. CONTACT PEOPLE

Stanley G. Andeel
Foulston & Siefkin
700 Fourth Financial Center
Wichita, KS 67202-2295
(316) 267-6371
FAX (316) 267-6345

T. C. Anderson
KS Society of Certified Public Accts.
400 Croix
PO Box 5654
Topeka, KS 66605
(913) 267-6460
FAX (913) 267-9278

Brad Bradley
Hinkle, Eberhart & Elkouri
2000 Epic Center
301 N. Market
Wichita, KS 67202-4820
(316) 267-2000
FAX (316) 264-1518

John Gerdes
Fleeson, Gooing, Coulson & Kitch
PO Box 997
125 N. Market, Suite 1600
Wichita, KS 67201
(316) 267-7361
FAX (316) 267-1754

Richard F. Hayse
Morris, Laing, Evans, Brock & Kennedy
914 Merchants National Bank
Topeka, KS 66612-1216
(913) 232-2662
FAX (913) 232-9983

Al Joseph
155 North Market
Suite 830
Wichita, KS 67202
(316) 265-9650
FAX (316) 264-3455

John R. Luttjohann
Wendling, Noe, Nelson & Johnson
1500 Bank IV Tower
Topeka, KS 66603
(913) 233-4226
FAX (913) 233-6830

Alson R. Martin
Shook, Hardy & Bacon
Building #40, Corporate Woods
9401 Indian Creek Parkway
PO Box 251-28
Overland Park, KS 66225
(913) 451-6060
FAX (913) 451-8879

Thomas G. Peebles
Kennedy & Coe
United Building
PO Box 1100
Salina, KS 67402-1100
(913) 825-1561
FAX (913) 825-5371

Dale G. Schedler
Lewis, Rice & Fingersh
Corporate Woods, Building #40
9401 Indian Creek Parkway, Suite 1100
Overland Park, KS 66210
(913) 451-8500
FAX (913) 451-8512

R. Scott Shackelford
Morrison, Hecker, Curtis, Kuder & Parrish
1700 Bryant Building
1102 Grand Avenue
Kansas City, MO 64106-2370
(816) 842-5910
FAX (816) 474-4208

John Wine
Office of the Secretary of State
2nd Floor, State Capitol
Topeka, KS 66612
(913) 296-2236
FAX (913) 296-4570

John Ensley
Goodell, Stratton, Edmonds & Palmer
515 S. Kansas Ave.
Topeka, KS 66603
(913) 233-0593
FAX (913) 233-8870

James Thomas
Gage & Tucker
2345 Grand Ave., Ste. 2800
Kansas City, MO 64141
(816) 292-2122
FAX (816) 292-2001

KBA The KANSAS BANKERS ASSOCIATION
A Full Service Banking Association

March 16, 1993

TO: House Judiciary Committee
RE: **SB 125** - Standard of Liability for Officers and Directors of Financial Institutions

Mr. Chairman and Members of the Committee:

The Kansas Bankers Association appears today in support of **SB 125**. The bill establishes a gross negligence standard of liability for breach of the duty of care in suits by banks against their outside directors or by the Federal Deposit Insurance Corporation (FDIC) or the Resolution Trust Corporation (RTC), in their capacity as conservator or receiver.

A recent decision by the U. S. Court of Appeals for the Tenth Circuit concerning a section of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) has created an inconsistent standard for the filing of suits against bank officers and directors. Due to the decision in the case of FDIC v. Canfield we now have a situation where the federal regulators could likely recover monetary damages upon proof of simple negligence against outside directors of a nationally-chartered bank in Kansas whereas they could only recover upon proof of gross negligence against outside directors of a state-chartered bank if the stockholders of that bank had adopted a resolution under the provisions of the Kansas Corporation Code to limit the liability of outside directors. The provisions of **SB 125** would create a gross negligence standard for outside directors of both state and national banks. Not only would this create equality for outside directors of all banks in Kansas, but it would also bring state law into conformity with federal law.

While there is an immediate necessity to clarify the state and national bank problem, it must also be emphasized that unless a more realistic standard for recovery of monetary damages is implemented the serious problem of finding and retaining qualified individuals for service on the boards of directors of banks throughout Kansas will continue to grow. This problem is becoming particularly acute for our community banks in the more rural areas of the state. When community leaders throughout the state see their peers in other communities being pulled into lengthy and costly court proceedings for no other reason than that they made a bad decision on a loan as a result of serving on the board of directors of a bank or S&L they are extremely reluctant to consider such service.

The provisions of federal law and the policies of federal regulatory agencies unfortunately encourage the filing of "deep pockets" law suits in an attempt to recover the

HOUSE JUDICIARY
Attachment #2
03-16-93

Office of Executive Vice President • 1500 Merchants National Building
Eighth and Jackson • Topeka, Kansas 66612 • (913) 232-3444
FAX (913) 232-3484

maximum amount for the agencies. Under no circumstances are we asking that the necessary and proper legal responsibilities of bank directors be diminished, but we are requesting that, as a result of the Canfield decision, the Legislature establish a reasonable and uniform standard for all outside directors of banks.

An amendment was added to **SB 125** in the Senate Judiciary Committee which we believe should be reviewed by this committee. It would maintain a simple negligence standard for any inside director or officer of a bank. We do not believe it is in the best interests of any financial institution to have certain members of a board of directors held to a one standard while other members are held to another standard. Certainly no other type of corporation in Kansas is subjected to this double standard under the corporation code and we know of only one other state in the entire country which has a similar division in their law. In addition, guidelines set forth by bank regulators make it abundantly clear that inside directors/officers will be held to more stringent "duty of care" than outside directors (see attached FDIC memo). We would strongly urge the committee to consider removing the Senate amendments (except for the stricken language) in order to create a uniform negligence standard for both officers and directors.

Attached to this testimony are comments by Charles Henson, general counsel for the KBA. He has clearly outlined why the provisions of **SB 125** are needed in Kansas. Also attached is a copy of the Canfield decision and a chart showing what the negligence standards are currently for officers and directors of state and national banks and what those standards would be with the Senate amendment and without the Senate amendment.

Thank you for the opportunity to appear in support of **SB 125**. We cannot emphasize too strongly the need to enact this legislation in order for banks, S&Ls, and credit unions throughout the state to be able to attract and retain qualified individuals to serve as directors. We request that the committee remove the Senate amendment discussed above and then report the bill favorably.

James S. Maag
Senior Vice President

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) contains a provision { 12 U.S.C. 1821 (k) } prescribing the standard under which the FDIC may recover monetary damages from officers and directors of insured depository institutions. This includes state and national banks. The standard prescribed is gross negligence or a greater degree of culpability.

It was thought by many that in actions brought by the FDIC, as conservator, receiver, etc. of a bank, this federal law preempted state laws which allowed recovery by a depository institution (and the FDIC in case of conservatorship, receivership, etc.) against its officers and directors for simple negligence. However, in the case of FDIC v. Canfield, 967 F.2d 443 (1992), the United States Court of Appeals for the Tenth Circuit held that 1821 (k) allows the FDIC to recover monetary damages from the officers and directors of insured depository institutions upon proof of simple, ordinary negligence, if such standard of care is applicable under state law. The court held the FIRREA provision preempts only state laws which require proof of a higher degree of culpability than gross negligence for the FDIC to recover.

To aid corporations to secure highly qualified persons to serve as directors, since 1985 more than 80% of the states have enacted some form of legislation designed to protect corporate directors form liability for monetary damages. Kansas enacted such legislation in 1987 when it amended the corporation code to add K.S.A. 17-6002 (b) (8). Under this provision, the Articles of Incorporation of a Kansas corporation, including a Kansas bank, may contain a provision eliminating the personal liability of a director to the corporation or its stockholders for monetary damages for breach of duty as a director, except the Articles of Incorporation may not limit the liability of a director for: (1) breach of duty of loyalty to the corporation or to its stockholders; (2) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (3) unlawful payment of dividends or unlawful stock purchases or redemptions; or (4) any transaction from which the director derives an improper personal benefit.

If the Articles of Incorporation of a Kansas state bank contain such a provision, under state law a director will be liable to the corporation or its stockholders for monetary damages for a breach of the duty of care only upon proof of intentional or knowing violations of law. Because of the

FIRREA provision as interpreted in FDIC v. Canfield, if suit for monetary damages is brought by the FDIC, as conservator, receiver, etc., of such a Kansas bank against its directors, the FDIC may recover upon proof of a lesser degree of negligence, i.e., gross negligence.

If the FDIC, as conservator receiver etc. seeks recovery against the directors of a Kansas national bank, under the FIRREA provision as interpreted in FDIC v. Canfield, it is likely the FDIC can recover monetary damages upon proof of simple negligence. National banks in Kansas cannot take advantage of the provision of the Kansas Corporate Code found at K.S.A. 17-6002 (b) (8).

It is the purpose and intent of **SB 125** to establish a single standard of liability for breach of the duty of care in suits by Kansas banks, state and national, against their officers and directors, or by the FDIC, as conservator, receiver, etc. of a Kansas bank. The standard is willful or gross and wanton negligence.

SB 125 is patterned after K.S.A. 17-6002 (b) (8) except that, in the case of Kansas banks, willful or gross and wanton negligence as a basis for recovery of monetary damages against officers and directors (the FIRREA standard for recovery by the FDIC) is substituted for the more stringent corporate code standard of intentional misconduct or knowing violation of law.

Under **SB 125**, the personal liability of officers and directors of Kansas banks, state and national, for breach of the duty of loyalty to the bank, or for any transaction for which the officer or director derives an improper personal benefit, would be unaffected, ~~except liability for an improper personal benefit would be limited to the amount of the benefit.~~ In the case of officers and directors of Kansas state bank, liability for violations of the banking code which concern unlawful payment of dividends or unlawful stock purchases or redemptions would be unaffected, just as the liability of the directors of Kansas corporations for violations of the corporate code for such actions is unaffected by K.S.A. 17-6002 (b) (8).

Doc. #49007

SB 125 Chart

	A	B	C	D	E	F	G
1	Type of bank	Current Negli-	Current Negli-	Negligence	Negligence	Negligence	Negligence
2		ence Standard	gence Standard	Standard for	Standard for	Standard for	Standard for
3		for Directors	for Officers	Directors If	Officers if	Directors if	Officers if
4				SB 125 Passes	SB 125 Passes	SB 125 Passes	SB 125 Passes
5				**without**	**without**	**with**	**with**
6				Senate	Senate	Senate	Senate
7				amendment	amendment	amendment	amendment
8							
9	State bank	gross	simple	gross	gross	gross	simple
10	using corporation						
11	code resolution						
12							
13	State bank not	simple	simple	gross	gross	gross	simple
14	using corporation						
15	code resolution						
16							
17	National bank	simple	simple	gross	gross	gross	simple

Attachment #2 - 5
03-16-93

FEDERAL DEPOSIT INSURANCE CORPORATION, Plaintiff-Appellant,

v.

Charles R. CANFIELD; Benjamin F. Armstrong; Theodore May; Newell P. Parkin; Mac Christensen; Richard A. Christenson; Dale R. Curtis; Frank Diston; Robert Garff; Lee K. Irvine; Ellis Ivory; Arch Madsen; Gus Paulos; Aline Skaggs; Ronald Swenson; Harold W. Milner; and Ernest Wilkinson, Defendants-Appellees.

Utah Bankers Association, the American Bankers Association, Gene Rice, Lola M. Rice, George E. Leonard, Jr., Mary Sandra Leonard, Gloria Leonard, Ernest F. Modzelewski, Nancy L. Modzelewski, Reginald T. Morrison, Catherine G. Morrison, Mel L. Decker, Clarice O. Decker, Donald S. Johnson, Marian E. Johnson, Gilberto I. Valdez, Gloria Ann Valdez, Hayden C. Hayden, Ms. Hayden C. Hayden, Peter C. Byrne, Mrs. Peter C. Byrne, Howard E. Kraff, Mrs. Howard E. Kraff, and Utah State Department of Financial Institutions, Amici Curiae.

No. 91-4143.

United States Court of Appeals, Tenth Circuit.

June 23, 1992.

Federal Deposit Insurance Corporation (FDIC) brought suit against former directors and officers of failed bank, seeking to hold them liable for their allegedly negligent management of bank. The United States District Court for the District of Utah, David Sam, J., 763 F.Supp. 533, granted motion of officers and directors to dismiss, and FDIC appealed. The Court of Appeals reversed, 957 F.2d 786, and on rehearing en banc, Seymour, Circuit Judge, held that section of Financial Institution Reform, Recovery, and Enforcement Act providing that director or officer could be held personally liable for monetary damages in any civil action by FDIC for gross negligence did not preempt state statutory or common law permitting such actions for simple negligence.

Reversed.

Brorby, Circuit Judge, filed dissenting opinion in which John P. Moore, Circuit Judge, joined.

John P. Moore, Circuit Judge, filed dissenting opinion.

1. Federal Courts ⟸776

Court of Appeals reviews construction of federal statutes de novo.

2. Banks and Banking ⟸50

States ⟸18.19

Section of Financial Institutions Reform Recovery and Enforcement Act (FIRREA) providing that director or officer of insured depository institution may be held personally liable for monetary damages in any civil action by Federal Deposit Insurance Corporation (FDIC) for gross negligence did not preempt state statutes or common-law permitting actions against officers and directors for simple negligence, but rather preempted only those state laws requiring higher degree of culpability than gross negligence in such actions. Federal Deposit Insurance Act, § 2[11](k), as amended, 12 U.S.C.A. § 1821(k); U.S.C.A. Const. Art. 6, cl. 2.

3. Statutes ⟸188

In construing statute, reliance must be placed on unambiguous statute's evident meaning.

4. Banks and Banking ⟸508

Phrase "other applicable law," in section of Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) providing that director or officer of insured depository institution could be held personally liable for monetary damages in civil action brought by Federal Deposit Insurance Corporation (FDIC) for gross negligence, and that nothing in paragraph should "impair or affect any right of the Corporation under other applicable law," meant all other applicable law. Federal

Attachment #2 - 6
03-16-93

Deposit Insurance Act, § 2[11](k), as amended, 12 U.S.C.A. § 1821(k).

See publication Words and Phrases for other judicial constructions and definitions.

5. States ⟸18.3

Field preemption, for federal law preemption purposes, cannot be inferred. U.S.C.A. Const. Art. 6, cl. 2.

Edward J. O'Meara, Counsel, F.D.I.C., Washington, D.C. (Ann S. Duross, Asst. Gen. Counsel, Richard J. Osterman, Jr., Sr. Counsel, and Jeffrey Ross Williams, Sr. Atty., F.D.I.C., Washington, D.C.; and Warren Patten and Craig T. Jacobsen of Fabian & Clendenin, Salt Lake City, Utah, of counsel, with him on the brief), for plaintiff-appellant F.D.I.C.

Robert S. Campbell, Jr. (Joann Shields of Campbell Maack & Sessions, Blake S. Atkin of Parry, Murray & Cannon, James R. Holbrook and Lynda Cook of Callister, Duncan & Nebeker, Michael N. Zundel of Jardine, Linebaugh, Brown & Dunn, Dale J. Lambert of Christensen Jensen & Powell, George J. Romney of Romney & Condie, and John W. Lowe, Salt Lake City, Utah, with him on the brief), for defendants-appellees.

James S. Jardine and Don B. Allen of Ray, Quinney & Nebeker, Salt Lake City, Utah, filed brief for amicus curiae Utah Bankers Ass'n.

John J. Gill, General Counsel, and Michael F. Crotty, Deputy General Counsel for Litigation, filed brief for amicus curiae American Bankers Ass'n.

Aaron M. Peck, Terry O. Kelly, and Carl W. Sonne of McKenna & Fitting, Peter K. Rosen of Rosen & Winston, Los Angeles, Cal., and Stephen M. Dichter, and Gregg H. Temple of Harrison, Harper, Christian & Dichter, P.C., Phoenix, Ariz., for amici curiae Gene Rice, Lola M. Rice, George E. Leonard, Jr., Mary Sandra Leonard, Gloria Leonard, Ernest F. Modzelewski, Nancy L. Modzelewski, Reginald T. Morrison, Catherine G. Morrison, Mel L. Decker, Clarice O. Decker, Donald S. Johnson, Marian E. Johnson, Gilberto I. Valdez, Gloria Ann Valdez, Hayden C. Hayden, Ms. Hayden C. Hayden, Peter C. Byrne, Mrs. Peter C. Byrne, Howard E. Kraff, and Mrs. Howard E. Kraff.

George Sutton, Com'r, Utah Dept. of Financial Institutions, Paul Van Dam, Atty. Gen. of State of Utah, Jan Graham, Utah Sol. Gen., Bryce H. Pettey, Asst. Atty. Gen., and Billy L. Walker, Sp. Asst. Atty. Gen., Salt Lake City, Utah, for amicus curiae Utah Dept. of Financial Institutions.

Before HOLLOWAY, LOGAN, SEYMOUR, MOORE, TACHA, BALDOCK, BRORBY, EBEL, and KELLY, Circuit Judges.

SEYMOUR, Circuit Judge.

This case requires our construction of section 212(k) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C. § 1821(k) (Supp. I 1989). The Federal Deposit Insurance Corporation (FDIC) brought this action in its corporate capacity seeking to hold the officers and directors of the failed Tracy Collins Bank & Trust Company liable under Utah law for their allegedly negligent management of the institution. *See* 12 U.S.C. § 1823(c), (d)(3)(A); *id.* § 1821(d)(2)[1]; *see also FDIC v. Bank of Boulder*, 911 F.2d 1466, 1468–71 (10th Cir. 1990), *cert. denied*, — U.S. —, 111 S.Ct. 1103, 113 L.Ed.2d 213 (1991). The district court granted defendants' motion to dismiss, holding that section 1821(k) preempts state law and bars the FDIC from seeking damages from officers and directors of failed institutions for simple negligence. *FDIC v. Canfield*, 763 F.Supp. 533 (D.Utah 1991). A panel of this court concluded that

1. Section 1821(d) provides:

(2) **General powers**

(A) **Successor to Institution**

The Corporation shall, as conservator or receiver, and by operation of law, succeed to—

(i) all rights, titles, powers, and privileges of the insured depository institution, and of any stockholder, member, accountholder, depositor, officer, or director of such institution with respect to the institution and the assets of the institution; ....

this holding was contrary to the plain language of section 1821(k) and reversed. We granted rehearing en banc and vacated the panel opinion. After considering additional briefing and hearing oral argument, we conclude that the panel was correct.

[1] "As in any case of statutory interpretation, we begin with the plain language of the law." *United States v. Morgan*, 922 F.2d 1495, 1496 (10th Cir.), *cert. denied*, — U.S. —, 111 S.Ct. 2803, 115 L.Ed.2d 976 (1991). "'Absent a clearly expressed legislative intention to the contrary, that language must ordinarily be regarded as conclusive.'" *Kaiser Aluminum & Chem. Corp. v. Bonjorno*, 494 U.S. 827, 110 S.Ct. 1570, 1575, 108 L.Ed.2d 842 (1990) (citation omitted). We review the construction of federal statutes de novo. *United States v. Temple*, 918 F.2d 134, 134 (10th Cir.1990).

[2] The central question in this appeal is whether section 1821(k) establishes a national standard of gross negligence for officers and directors in actions brought by the FDIC, and thereby preempts state statutory or common law permitting such actions for simple negligence. The statute provides:

> *A director or officer of* an insured depository institution *may be held personally liable* for monetary damages in any civil action by, on behalf of, or at the request or direction of the Corporation, which action is prosecuted wholly or partially for the benefit of the Corporation—
>
> (1) acting as conservator or receiver of such institution,
>
> (2) acting based upon a suit, claim or cause of action purchased from, assigned by, or otherwise conveyed by such receiver or conservator, or
>
> (3) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed in whole or in part by an insured depository institution or its affiliate in connection with assistance provided under section 1823 of this title,
>
> *for gross negligence*, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are *defined and determined under applicable State Law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.*

12 U.S.C. § 1821(k) (emphasis added).

The district court held, and defendants argue, that section 1821(k) preempts state law and limits the FDIC's ability to pursue recovery from officers and directors to those cases in which it can demonstrate gross negligence under the applicable state definition. Under this interpretation, an action like this one, enabled by state law and sounding in simple negligence, would therefore be barred by the statute.

The FDIC contends that the statute preempts only those state laws that require a higher degree of culpability than gross negligence in actions brought by the FDIC against officers and directors.[2] Under the FDIC's construction, the last sentence of section 1821(k) is a "savings clause" that saves a simple negligence action against officers and directors of a failed bank in a

2. Recently, numerous states have acted to insulate officers and directors from liability. At least two states require willful or wanton conduct in order for liability to attach. *See* Ind. Code Ann. § 23-1-35-1(e) (West 1991); Wis. Stat.Ann. § 180.0828(1) (West 1992). Other states have adopted less extreme approaches. *See, e.g.*, Va.Code Ann. § 13.1-690 (Michie 1989) (good faith business judgment). Some states permit corporations to opt into a restriction on liability. For example, the Colorado statute authorizes a corporation to adopt "a provision to eliminate or limit the personal liability of a director ... for monetary damages for breach of fiduciary duty as a director." Colo.Rev.Stat. § 7-3-101(1)(u). For a chart summarizing the various state laws, *see* James J. Hanks, Jr., *Recent State Legislation on D & O Liability Limitation*, 43 Bus.Law. 1207, 1246-54 (1988). For a general discussion of the issue, *see id.* at 1243 ("Since 1985, more than four-fifths of the states have enacted some form of legislation designed to protect directors from money damages."); Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 Fordham L.Rev. 375 (1988).

state where such an action is otherwise permissible.[3]

In our judgment, the words used in section 1821(k) to describe the potential liability of officers and directors belie the creation of an exclusive federal liability standard. The section provides that "a director or officer *may* be held personally liable for monetary damages ... for gross negligence." 12 U.S.C. § 1821(k) (emphasis added). "May" is a permissive term, and it does not imply a limitation on the standards of officer and director liability. *See Rose v. Rose,* 481 U.S. 619, 626–27, 107 S.Ct. 2029, 2034, 95 L.Ed.2d 599 (1987) (Court refused to read "may" as establishing anything other than discretionary power). FIRREA enables the FDIC to stand in the shoes of the failed bank and its stockholders and to sue the officers and directors for mismanagement under state law. *See* 12 U.S.C. § 1821(d)(2) *infra* n. 1; *id.* § 1823(c), (d)(3)(A). In this context, no reasonable construction of "may" results in an absolute limitation of the liability of officers or directors to instances of gross negligence. Rather, the first sentence of section 1821(k) effectively provides that even where state law under which the FDIC is authorized to bring suit otherwise limits actions against officers and directors to *intentional* misconduct, an officer or director may nevertheless be held liable for gross negligence. In states where an officer or director is liable for simple negligence, however, the FDIC may rely, as it does in this case, on state law to enable its action.

In order to uphold the district court's construction of section 1821(k), we would have to construe the first sentence of the section as saying that an officer or director *may only* be held personally liable for gross negligence. This would require us to insert a word into the statute, and we decline to do so. *See Resolution Trust Corp. v. Lightfoot,* 938 F.2d 65, 66–67 (7th Cir. 1991) ("may" does not, on its face, mean "may only").

[3, 4] The last sentence of the statute cements our understanding of it. In construing a statute, reliance must be placed on an unambiguous statute's "evident" meaning. *See Small v. Britton,* 500 F.2d 299, 301 (10th Cir.1974). With this in mind, we believe that "other applicable law" means *all* "other applicable law."[4] Under the statute then, any other law providing that an officer or director may be held liable for simple negligence survives; such a law would be an "other applicable law," and construing the statute to bar its application would "impair" the FDIC's rights under it.

It is a general rule of construction that the statute should be read as a whole. 2A N. Singer, *Sutherland Statutory Construction* § 46.05 (5th ed. 1992). Linguistic choices made by Congress in other sections of FIRREA enrich our understanding of the choice made by Congress in section 1821(k). Unless the rest of the statutory scheme gives us reason to think that section 1821(k) does not mean what it says, we

3. The district courts that have considered this question are split, but a clear majority agrees with the FDIC's interpretation. *See FSLIC v. Shelton,* 789 F.Supp. 1360 (M.D.La.1992) (following panel opinion); *FDIC v. Williams,* 779 F.Supp. 63 (N.D.Tex.1991) (rejecting district court opinion in this case); *FDIC v. Miller,* 781 F.Supp. 1271 (N.D.Ill.1991) (same); *FDIC v. Isham,* 777 F.Supp. 828 (D.Colo.1991) (same); *FDIC v. Black,* 777 F.Supp. 919 (W.D.Okla.1991) (same); *FDIC v. McSweeny,* 772 F.Supp. 1154 (S.D.Cal.1991) (same); *FDIC v. Fay,* 779 F.Supp. 66 (S.D.Tex.1991) (same); *FDIC v. Haddad,* 778 F.Supp. 1559 (S.D.Fla.1991) (same); *FDIC v. Burrell,* 779 F.Supp. 998 (S.D.Ia.1991) (same). *But see FDIC v. Brown,* No. NC89-306, 1991 WL 294524 (D.Utah Nov. 18, 1991); *FDIC v. Swager,* 773 F.Supp. 1244 (D.Minn.1991).

The two circuit opinions that have discussed section 1821(k) do not decide the issue facing us. *See Home Sav. Bank, F.S.B. v. Gillam,* 952 F.2d 1152 (9th Cir.1991); *Gaff v. FDIC,* 919 F.2d 384, 391 (6th Cir.1990). As a result, we are the first court of appeals to directly address the scope of section 1821(k).

4. In *Patterson v. Shumate,* — U.S. —, 112 S.Ct. 2242, 119 L.Ed.2d 519 (1992), the Supreme Court read the phrase "applicable nonbankruptcy law" used in 11 U.S.C. § 541(c)(2) to include state and federal law. "Plainly read, the provision encompasses any relevant nonbankruptcy law, including federal law such as ERISA. We must enforce the statute according to its terms." *Id.* at 2247. This principle applies with equal force here.

will take the statute at its word. In other parts of section 1821, the statute refers specifically to the other bodies of law it touches. *See, e.g.*, 12 U.S.C. § 1821(c)(3)(B) ("powers imposed by State law"); *id.* (c)(4) ("notwithstanding any other provision of Federal law, the law of any State"). Similarly, when the statute refers only to itself, it does so specifically. *See, e.g., id.* (d)(2)(I) (FDIC may "take any action authorized by this chapter"); *id.* (e)(3)(C)(ii) ("except as otherwise specifically provided in this section"). Finally, when the statute refers to the whole universe of other laws, it uses the same language employed in section 1821(k). *See id.* (e)(12)(B) ("No provision of this paragraph may be construed as impairing or affecting any right ... under other applicable law."). Consideration of the pattern of usage in the rest of FIRREA therefore supports the position of the FDIC. It runs squarely against the suggestion of defendants that "other applicable law" refers to the FDIC's powers in "other contexts," Appellee's Answering Brief at 20, and the conclusion of the district court that it applies to other sections of FIRREA itself, *Canfield*, 763 F.Supp. at 537.

Defendants urge that the "other applicable law" language refers to the FDIC's rights in other contexts. By this they apparently mean rights of the FDIC against officers and directors, under state or federal law, to seek remedies *other than* personal damages. Any other interpretation of the last sentence, they reason, would eviscerate the attempt to create a national standard of liability. The problem with this argument is that it limits the statutory language by fiat. Nowhere does the statute announce its intention to create a national standard of liability, and the vehemence of the assertions to the contrary made by defendants will not persuade us to interpret the statute in light of a fiction. We refuse to depart from the principle of "general adherence to the words of the statute as commonly understood.... [O]ur limited function, in deference to the legislative process, is to interpret and apply the law, not to make it." *Miller v. Commissioner*, 836 F.2d 1274, 1281 (10th Cir. 1988).

The statute's reliance on state law for its definition of gross negligence directly refutes the proposition that FIRREA establishes a national standard of liability for officers or directors.[5] State law definitions of gross negligence differ. Indeed, "there is ... no generally accepted meaning [of gross negligence]." W. Page Keeton, et al., *Prosser and Keeton on the Law of Torts* § 34, at 212 (5th ed. 1984). These differences mean that the statute cannot possibly, even without the last sentence, create a national standard of liability. Instead, section 1821(k) limits the ability of the states to insulate officers and directors of federally insured institutions from liability. Once the notion of a national standard is dismissed, the function of the last sentence becomes clear. "[I]t is difficult to think of a more appropriate place to put a *general saving clause* than where Congress placed it—at the conclusion of the section setting out a special procedure for use in certain specified instances." *Abbott Labs. v. Gardner*, 387 U.S. 136, 145, 87 S.Ct. 1507, 1513–14, 18 L.Ed.2d 681 (1967) (emphasis added). Under section 1821(k), states may require that the FDIC show "gross negligence," under the state definition, in order to establish an officer or director's personal liability. They simply may not require greater culpability.

The officers and directors offer a reading of section 1821(k) contrary to the established principle of statutory construction that "[a] statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous." 2A N. Singer, *Sutherland Statu-*

5. In a different context, where Congress intended to create a national standard, the Supreme Court adopted a national definition of "burglary," rather than relying on state law definitions. *See Taylor v. United States*, 495 U.S. 575, 110 S.Ct. 2143, 109 L.Ed.2d 607 (1990) (construing 18 U.S.C. § 924(e)). Section 924(e) does not refer to any source for the definitions of the terms it employs. *See* 18 U.S.C. § 924(e) (1988). Here, the specific choice to rely on state law definitions of gross negligence directly supports our conclusion that Congress did not adopt a national standard of officer and director liability when it enacted section 1821(k).

tory Construction § 46.06. Under defendants' suggested interpretation, both the first and the second sentence say the same thing. The first sentence announces the exclusive liability standard, while the second makes the same announcement in a different form. The second sentence thus serves no independent purpose; it merely explicitly limits the application of the gross negligence standard to actions against officers and directors for money damages. This construction is necessarily less compelling than our construction, which gives each of the sentences independent force.

[5] In the face of the language, defendants in effect assert that section 1821(k) preempts the field of liability law governing officers and directors of federally insured institutions. Importantly, "field preemption cannot be inferred." *Wisconsin Public Intervenor v. Mortier,* — U.S. —, 111 S.Ct. 2476, 2486, 115 L.Ed.2d 532 (1991). It is true that "[a]bsent explicit pre-emptive language, Congress' intent to supersede state law in a given area may nonetheless be implicit if a scheme of federal regulation is 'so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it.'" *Id.* at 2481 (citation omitted). In this case, the explicit preemptive language moves in only one direction and its scope is explicitly limited. The statute blocks only those state laws that require more than gross negligence in order to establish the personal liability of directors and officers. By saving "other applicable law," the statute makes unreasonable any inference that the entire field was the target of the legislation. "Preemption should not ... be presumed absent *a clear manifestation* of federal intent to exclude state law provisions." *Guschke v. City of Oklahoma City,* 763 F.2d 379, 383 (10th Cir.1985) (emphasis added). At the very least, the statutory language fails to evince a "clear manifestation of federal intent" to preempt claims like the one brought by the FDIC below.

The policy arguments marshalled by the officers and directors against a negligence standard are addressed to the wrong forum. By saving "other applicable law," Congress left it to the states to decide the propriety of a simple negligence standard. In reaching that decision, a state may well choose to consider the difficulty of obtaining liability insurance, and the need to attract those people defendants claim will not accept directorships under a simple negligence standard. Unlike a state legislature making such a policy choice, we are in no position to weigh these factors. Instead, we may consider only whether the statute prohibits the FDIC from pursuing the action it has filed in Utah against these defendants. On its face, section 1821(k) does not do so.[6]

6. The legislative history is consistent with our interpretation of the statute's plain language. As originally proposed in the Senate, the provision would have held officers and directors liable for "any cause of action available at common law, including ... simple negligence," thus totally preempting all more restrictive state laws. S. 774, 101st Cong., 1st Sess. § 214(n) (1989). During the Senate debate, the proposal was modified. Senator Riegle, the bill's floor manager, explained the purpose of the amendment:

> In recent years, *many States have enacted legislation that protects directors or officers of companies from damage suits.* These 'insulating' statutes provide for various amounts of immunity to directors and officers. For example, in Indiana, a director or officer is liable for damages only if his conduct constitutes "willful misconduct or recklessness."
>
> *The reported bill totally preempted state law* in this area, with respect to suits brought by the FDIC against bank directors and officers. However, *in light of the state law implications raised by this provision, the manager's amendment scales back the scope of this preemption.*

135 Cong.Rec. S4278–79 (daily ed. April 19, 1989) (emphasis added). Two other senators, Roth and Garn, specifically commented on the limited preemptive scope of the section. *See id.* at S4281.

The Conference Report, relied on by defendants, is not to the contrary. It provides that: "The preemption *allows* the FDIC to pursue claims for gross negligence or any conduct that demonstrates a greater disregard of a duty of care, including intentional tortious conduct." *Id.* 1989 U.S.C.C.A.N. 86,437. (emphasis added). The language of the report merely explains that the section *allows* actions for gross negligence. It is thus consistent with the partial preemption interpretation of the statute.

Finally, the language of the final Senate Report fully supports our result. Discussing the amended section, the report states: "This sub-

Attachment #2 — 11
03-16-93

Finally, under defendants' interpretation, consider the position of an officer or director of a troubled federally insured institution in a state allowing actions for negligence. Prior to failure, liability would attach for simple negligence. After failure, liability would only attach if the officer or director could be proven grossly negligent under the applicable state definition. As the institution struggles, therefore, section 1821(k) would create an incentive for the officers and directors to allow the bank to fail. It simply cannot be that FIRREA would indirectly encourage such behavior, when it was designed in part, according to its stated purposes, "to *curtail ... activities of savings associations that pose unacceptable risks* to the Federal deposit insurance funds." FIRREA, Pub.L. No. 101–73, § 101(3), 103 Stat. 183, 187 (1989) (emphasis added).

We hold that the plain language of the statute demands reversal of the district court's opinion in this case. "In so concluding we do nothing more, of course, than follow the cardinal rule that a statute is to be read as a whole, since the meaning of statutory language, plain or not, depends on context." *King v. St. Vincent's Hosp.,* — U.S. —, 112 S.Ct. 570, 574, 116 L.Ed.2d 578 (1991).

Accordingly, the decision of the court below is REVERSED.

BRORBY, Circuit Judge, respectfully dissenting.

Few are so naive as to believe there exists but a single correct interpretation of any given statute. Those who are intellectually honest admit the real question is: Which "correct" interpretation will the court adopt, and why?[1]

The parties in this case have aptly illustrated that Congress' choice of language in 12 U.S.C. § 1821(k) is susceptible to two valid yet opposing interpretations. The majority has adopted the FDIC's interpretation—the plain words of § 1821(k) do not create an exclusive federal standard of liability for bank directors and officers in civil damages suits brought by the FDIC. This interpretation is supportable and the majority opinion is well written; however, I fear the majority has lost sight of the forest but for a single tree. When construing statutes we must remember "laws are not abstract propositions. They are expressions of policy arising out of specific situations and addressed to the attainment of particular ends." Felix Frankfurter, *Some Reflections on the Reading of Statutes,* 47 Colum.L.Rev. 527 (1947), *reprinted in* 3 N. Singer, *Sutherland Statutory Construction* 265, 272 (4th ed. 1986). Believing the majority has construed the phrase "other applicable law" in isolation from the substantive import of § 1821(k) and the overriding objectives of the national banking system, I respectfully dissent. The better interpretation of § 1821(k)—the interpretation advocated by defendant directors and officers and numerous Amici Curiae—not only gives effect to the plain language of the statute, but also serves Congress' longstanding goal to achieve uniform administration of federal financial institutions and heeds important public policy concerns which underlie this legislation.

Congress enacted § 1821(k) of FIRREA as part of its extensive revision of the national banking system and "to nationalize the law of directors' and officers' liability when banks are taken over by the FDIC." *Gaff v. FDIC,* 919 F.2d 384, 391 (6th Cir.1990).[2] The substantive import of

section does not prevent the FDIC from pursuing claims under State law or other applicable Federal law, if such law permits the officers or directors of a financial institution to be sued (1) for violating a lower standard of care, such as simple negligence." 135 Cong.Rec. S6912 (daily ed. June 19, 1989).

1. For nearly every canon of statutory construction, there exists an opposing canon which supports a contrary interpretation. *See* Karl N. Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes are to be Construed,* 3 Vand.L.Rev. 395 (1950), *reprinted in* 3A N. Singer, *Sutherland Statutory Construction* 203, 206–09 (4th ed. 1986).

2. Although the interpretation of § 1821(k) was not squarely before the *Gaff* court, the Sixth Circuit's reading of § 1821(k) was integral to its holding that federal law totally preempts state law under various FIRREA sections, including § 1821(k).

Statement Concerning the Responsibilities of Bank Directors and Officers

The Federal Deposit Insurance Corporation is issuing this statement in response to concerns expressed by representatives of the banking industry and others regarding civil damage litigation risks to directors and officers of federally insured banks.

Duties of Directors and Officers

Service as a director or officer of a federally insured bank represents an important business assignment that carries with it commensurate duties and responsibilities.[1]

Banks need to be able to attract and to retain experienced and conscientious directors and officers. When an institution becomes troubled, it is especially important that it have the benefit of the advice and direction of people whose experience and talents enable them to exercise sound and prudent judgment.

Directors and officers of banks have obligations to discharge duties owed to their institution and to the shareholders and creditors of their institutions, and to comply with federal and state statutes, rules and regulations. Similar to the responsibilities owed by directors and officers of all business corporations, these duties include the duties of loyalty and care.

The duty of loyalty requires directors and officers to administer the affairs of the bank with candor, personal honesty and integrity. They are prohibited from advancing their own personal or business interests, or those of others, at the expense of the bank.

The duty of care requires directors and officers to act as prudent and diligent business persons in conducting the affairs of the bank.

This means that directors are responsible for selecting, monitoring, and evaluating competent management; establishing business strategies and policies; monitoring and assessing the

---

[1] The regulatory agencies and others have produced guides that provide useful advice on ways directors can meet their duties to their institutions. These include the Pocket Guide for Directors (FDIC, 1988), The Director's Book (OCC, 1987), and FHLBB, Memorandum No. R 62, *reprinted* at 52 Fed. Reg. 22,682, 22,683 (1987). *See also* The Director's Guide: The Role and Responsibilities of a Savings Institution Director (FHLB-SF, 1988).

progress of business operations; establishing and monitoring adherence to policies and procedures required by statute, regulation, and principles of safety and soundness; and for making business decisions on the basis of fully informed and meaningful deliberation.

Officers are responsible for running the day to day operations of the institution in compliance with applicable laws, rules, regulations and the principles of safety and soundness. This responsibility includes implementing appropriate policies and business objectives.

Directors must require and management must provide the directors with timely and ample information to discharge board responsibilities. Directors also are responsible for requiring management to respond promptly to supervisory criticism. Open and honest communication between the board and management of the bank and the regulators is extremely important.

The FDIC will not bring civil suits against directors and officers who fulfill their responsibilities, including the duties of loyalty and care, and who make reasonable business judgments on a fully informed basis and after proper deliberation.

Procedures Followed to Institute Civil Lawsuits

Lawsuits brought by the FDIC against former directors and officers of failed banks are instituted on the basis of detailed investigations conducted by the FDIC. Suits are not brought lightly or in haste.

The filing of such lawsuits is authorized only after a rigorous review of the factual circumstances surrounding the failure of the bank. In addition to review by senior FDIC supervisory and legal staff, all lawsuits against former directors and officers require final approval by the FDIC Board of Directors or designee.

In most cases, the FDIC attempts to alert proposed defendants in advance of filing lawsuits in order to permit them to respond to proposed charges informally and to discuss the prospect of prefiling disposition or settlement of the proposed claims.

The FDIC brings suits only where they are believed to be sound on the merits and likely to be cost effective. On that basis, where investigations have been completed, the FDIC has brought suit (or settled claims) against former directors and officers with respect to 24% of the banks that have failed since 1985.

Nature of Suits Filed

The FDIC's lawsuits are premised on the established legal principles that govern the conduct of directors and officers. Lawsuits against former directors and officers of failed banks result from a demonstrated failure to satisfy the duties of loyalty and care. Most suits involve evidence falling into at least one of the following categories:

- Cases where the director or officer engaged in dishonest conduct or approved or condoned abusive transactions with insiders.

- Cases where a director or officer was responsible for the failure of an institution to adhere to applicable laws and regulations, its own policies or an agreement with a supervisory authority, or where the director or officer otherwise participated in a safety or soundness violation.

- Cases where directors failed to establish proper underwriting policies and to monitor adherence thereto, or approved loans that they knew or had reason to know were improperly underwritten, or, in the case of outside directors, where the board failed to heed warnings from regulators or professional advisors, or where officers either failed to adhere to such policies or otherwise engaged in improper extensions of credit. Examples of improper underwriting have included lending to a borrower without obtaining adequate financial information, where the collateral was obviously inadequate, or where the borrower clearly lacked the ability to pay.

One factor considered in determining whether to bring an action against a director is the distinction between inside and outside directors. An inside director is generally an officer of the institution, or a member of a control group. An inside director generally has greater knowledge of and direct day to day responsibility for the management of the institution.

By contrast, an outside director usually has no connection to the bank other than his directorship and, perhaps, is a small or nominal shareholder. Outside directors generally do not participate in the conduct of the day to day business operations of the institution. The most common suits brought against outside directors either involve insider abuse or situations where the directors failed to heed warnings from regulators, accountants, attorneys or others that there was a significant problem in the bank which required correction. In the latter instance, if the directors fail to take steps to implement corrective measures, and the problem continued, the directors may be held liable for losses incurred after the warnings were given.

December 3, 1992

A. S. [...]T & SONS, INC.
Serving Bankers Since 1867

Pratt's Letter

Ahead of the News/The Story Behind the News

The Washington Authority on Banking and Finance

1911 FORT MYER DR.
POST OFFICE BOX 9655
ARLINGTON, VA 22219-0655
PHONE (703) 528-0145

Washington, March 5, 1993

Dear Reader:

ROUTE TO:
Jim
Chad
Kat
Amy
John

INSIDER LIABILITY

The FDIC and RTC are caught in a cross fire of criticism over the issue of officer and director liability suits.

From one side, that relentless Congressional duo, Banking Committee Chairmen Gonzalez and Riegle, along with their General Accounting Office henchmen, are pressuring the regulators to pursue such claims more aggressively.

As GAO Associate Director Harold Valentine bluntly put it a few weeks ago, "...FDIC and RTC have not done all they could to pursue professional liability claims against former directors, officers, and other professionals of failed thrifts and banks."

Valentine reported that senior FDIC headquarters and field officers had told GAO they have found indications of suspected wrongdoing by directors, officers, or other professionals in 90 percent of failed banks and that the agency anticipated filing a claim in 75 percent of the banks that failed in 1990 and 1991.

The most common claim, said Valentine, is for participation in unsafe or unsound banking practices (particularly for the approval of loans that were patently bad at inception).

Valentine reported that since 1989, the FDIC and RTC have recovered over $1.7 billion from professional liability claims. At the end of 1992, the RTC had 191 claims pending that involved nearly $7 billion, while the FDIC had 589 pending claims involving an undetermined amount.

But however impressive they may seem, these figures are all too little, in the view of some on Capitol Hill.

Meanwhile, many in the banking industry assert the supervisors have gone overboard in their efforts to recoup losses from failed banks and thrifts. The recent *National Bank of Washington* decision (LETTER, February 19) may help add weight to those bankers' argument.

The FDIC has to be embarrassed by Judge Royce C. Lamberth's decision in the *NBW* case. The U.S. district court judge dismissed, with prejudice, 38 of the 42 counts the FDIC had filed against ten directors and one officer of the now-defunct bank.

Because 16 of those counts were brought with what Lamberth called "full knowledge that they were not ripe," the court ordered the FDIC to pay the defendants' costs and attorney fees incurred in defense of those claims. "Here it is evident," the court said, "that FDIC was trying to recoup as much of NBW's loss as possible. However, it did so by filing sixteen claims that were insupportable as a matter of law."

The court said it would leave to "the bureaucracy of the United States the task of affixing responsibility between the Justice Department and FDIC. Unfortunately for the federal taxpayers, they are stuck either way."

~~Attachment~~ #2 - ~~1~~ 16
03-16-93

Judge Lamberth also ridiculed the FDIC's assertion that NBW's directors should have dishonored the CEO's golden parachute severance arrangement. "FDIC challenges the payment...even though two outside law firms, corporate counsel, and the OCC all failed to recommend to the directors that they should even consider reneging on this binding legal obligation.... [F]or all of FDIC's post-hoc rationalization, all evidence clearly reveals that the directors were not negligent."

Although Lamberth's opinion seems to muddy the judicial waters with regard to what standard of negligence should apply to bank directors, his conclusions are nothing less than solid body blows to the FDIC's professional liability section.

No matter which of two alternative standards--gross or simple negligence--is applied to the *NBW* case, the FDIC loses, according to Lamberth. "Here," he said, "FDIC attempts to recover for a claim which only in hindsight appears imprudent."

At another point: "Courts recognize that even disinterested, well-intentioned, informed directors can make decisions that, in hindsight, were imprudent. To impose liability on directors for these good faith business decisions, however, would effectively destroy the corporate system in this country, for no individuals would serve as officers and directors."

CRA IN BHC DECISIONS

The Community Reinvestment Act played a significant role in two bank holding company applications processed recently by the Federal Reserve Board. While both applications were approved, the approvals came only after a close scrutiny and extended discussion of the applicants' CRA performance.

In the case of Bank One's application to acquire Valley National Corporation, the Fed was inundated with 60 different comment letters from the public, split roughly in half between supporters and opponents. (Some opponents actually argued that the Fed should delay its decision until the Clinton Administration has a chance to propose rewriting the Community Reinvestment Act to its liking.)

One complicating issue in the Bank One case was the fact that the OCC had just assigned Bank One's Cleveland subsidiary a preliminary CRA rating of "needs to improve." The FRB declined to reject the application on this basis, however, since 19 Bank One subsidiaries--including its lead bank--have "outstanding" CRA ratings, and 41 other subsidiaries are rated "satisfactory."

Separately, the Fed made short work of disposing of CRA-based objections to the application of Comerica Incorporated, Detroit, to acquire the parent BHC of NorthPark National Bank, Dallas.

The FRB noted in its decision that "a CRA examination is an important, and often controlling, factor in the consideration of an institution's CRA record..." and that all of Comerica's banks were rated either "outstanding" or "satisfactory."

In both cases, the Reserve Board found that the holding companies had in place the kind of policies and procedures that lead to good CRA performance, that they had effective programs for ascertaining the credit needs of the community, and that their lending programs and practices generally provided good service to low- and moderate-income areas. Also, the Fed found no evidence of illegal racial discrimination, despite some racial disparities in reported HMDA data. (Bank One, *Doc. No. 0305A, 17 pages. Comerica, *Doc. No. 0305B, 16 pages.)

Attachment #2 — 18
03-16-93

For Some Directors, '91 Law Is Last Straw

Continued from *page* **1**

out, last year's Federal Deposit Insurance Corp. Improvement Act will only make their jobs harder.

Consider the case of Clay Farha, who resigned in October after three years on the board of Community Bank and Trust Co., a $163 million-asset institution in Oklahoma City. He was terrified of being hit with a lawsuit.

Mr. Farha's father had been sued for the part he allegedly played in 1984 as a director of a failed savings and loan in Wichita, Kan.

"I was thoroughly enjoying the position until I saw what kind of nightmare my Dad went through," said the son, 33, who runs a property management company.

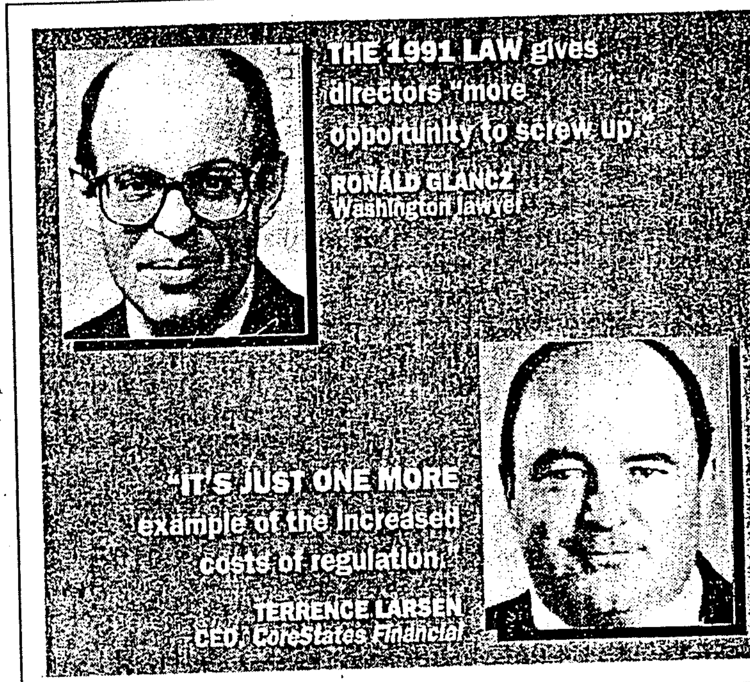
"What keeps me from thinking the FDIC won't eight years from now go after me like they went after my father? I can't put my family through that kind of heartache," he said.

Thus did the bank board seat, which supposedly betokens business success and community prominence, quickly lose its allure.

Not Worth the Trouble

For Mr. Farha, neither the prestige of a directorship nor the remuneration – $6,000 a year, which he was putting toward his daughter's education – was enough to ease the headaches.

Directors of larger banks may not be as nervous. They have big



mittee members. These board members must pore over auditors' reports and literally vouch for their institutions' health and compliance with regulations.

The law gives directors "more opportunities to screw up," said Ronald Glancz, a partner with Venable, Baetjer, Howard & Civiletti in Washington.

While many of the larger banks already have audit committees, until now there have been few rules governing their operation.

As proposed, FDIC regulations would make all banks larger than $150 million in assets subject to the rules. They would

contrary, he said, most suits are filed when regulators and auditors have told a board they have a problem and the board doesn't take steps to bring it under control.

The Office of Thrift Supervision sought to assuage concerns among thrift directors in guidelines issued on Nov. 16. The OTS enumerated directors' obli-

Many board members fear they'll be sued for matters

In this climate of fear, fewer insurance companies will write policies to protect directors from regulatory suits.

The impact is most pronounced at banks with less than $1 billion in assets. A survey this year by Huggins & Associates of Memphis, found that 74% of banks in that size range were having more trouble hiring directors.

But larger banking companies are also feeling the effects.

John McCoy, chairman and chief executive officer of Banc One Corp., said he is having trouble finding outside directors for its Texas bank. "Almost every good person who's been on a board has been sued or is being sued. So when you ask, they say, 'You've got to be a blooming idiot,'" Mr. McCoy said.

All Eyes on the Courts

Most legal experts say bankers and directors will be watching the courts more than the evolution of the FDICIA audit rules.

Two federal court decisions, FDIC v. Canfield and FDIC v. McSweeney, already have upheld laws in Utah and California that allow directors to be sued for "simple negligence," encompassing relatively minor infractions like making bad loans.

More decisions like these could spread more panic, but there is also the possibility that the frequency of such decisions, and suits filed, could tail off.

Power Has Its Price

If the recent laws were aimed

·arnings in recent years.

·ital Idea

o. this perception, a ·ould sell a stake in a trans- processing unit to the ·, boosting the bank's stock while giving the technol- unit more capital with · to make acquisitions.

·ong those eyeing such a is National City Corp. in land. "We've always been ·ated and don't believe that nalysts out there give us ·h credit for our fee busi- es," said Delroy R. ng ·resident of National ·ssing Co., National City's hant and item processing in Louisville, Ky.

lliam R. Robertson, the 's deputy chairman, said issuing separate stock for ·nal Processing, and selling ke to the public, could be an ctive move for several rea- . including the fact that the nology unit might be able to e acquisitions the bank dn't.

$100 Million Limit

c explained that National is currently constrained ı uiring technology com- ies ·osting more than $100 ion.

·ne reason is that larger ac- ·itions – if made with cash – ld burden the bank's balance ·t with too many intangibles ı would have to be written off inst earnings and capital over w years.

·he bank also has difficulty uiring technology companies ·ough exchanges of equity.

See SPINOFFS page 3

a small portion of an $875 million bank loan obtained just months ago. *Page 5*

INTERNATIONAL

BANK OF BOSTON is mapping plans to expand in Mexico, pending approval of the North American Free Trade Agreement. *Page 2*

CITICORP said Thursday that it had sold its 7.9% stake in the Mexican beverage company Fomento Economico Mexicano SA, known as Femsa, to Philip Morris. *Page 5*

PEOPLE

'ON THE BRINK' authors Edward W. Hill and Roger J. Vaughan say they were surprised by the furor created by their book, which made dire forecasts for the industry. *Page 2*

COMMENT

LEVERAGED LENDING has staged a remarkable recovery – but with a difference. Recent high-margin transactions were primarily refinancing deals, including reverse leveraged buyouts, writes Joseph V. Rizzi. *Page 4*

INDEX

Hibernia Corp. cleared two important hurdles this week in its effort to rebuild capital.

The New Orleans company obtained the minimum number of initial subscriptions needed to proceed with a rights offering to shareholders aimed at raising $75 million of equity.

Offer Going Well

In addition, Hibernia got clearance Monday from the Federal Reserve Board to sell its Texas bank to Detroit-based Comerica Inc. for $58 million. Hibernia began the offering on Nov. 12, with the aim of selling 20 million shares. The offering is scheduled to end next Thursday.

The company has initial subscriptions for about 1.8 million shares, the minimum set in a September agreement with a group of seven creditors led by Chase Manhattan Bank.

At the time, the creditors agreed to swap $99 million in debt, on which Hibernia had de-

See CAPITAL back page

trade groups – the American Bankers Association and Independent Bankers Association of America.

The letter is also expected to be signed by the Association of Bank Holding Companies, the Association of Reserve City Bankers, and the Consumer Bankers Association. It is to be delivered to the Clinton camp today or Monday.

The trade groups agreed not to discuss the letter officially until

See TRADE GROUPS page 9

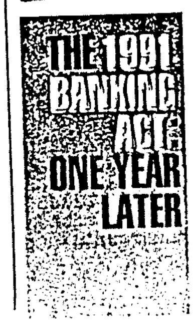
Attachment #2 — 19
03-16-93

For Some Directors, '91 Law Is Last Straw

By FRED VOGELSTEIN
Last of a Series

The once-cozy bank director's chair has turned into a hot seat.

Thanks in part to last year's banking law, a growing number of board members are living in fear of being sued for matters they believe are beyond their control. The feeling is especially prevalent at community banks.



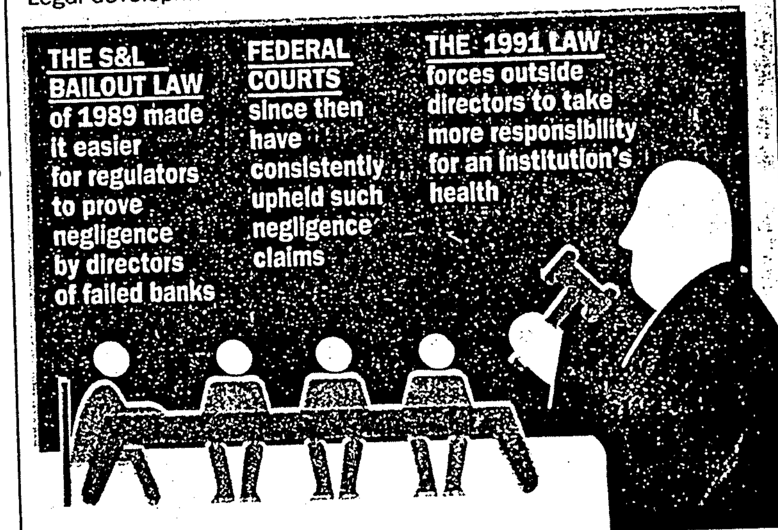
Regulators insist that such concerns are overblown. They defend a recent increase in lawsuits, primarily against directors of failed thrifts, as necessary to hold boards more accountable for their institutions.

Maybe so, but just the possibility of a suit has been enough to scare some directors away.

The disenchantment started with changes in the thrift bailout law of 1989. And for those board members who haven't bailed

See FOR SOME page 13

Here Comes the Judge
Legal developments that are making bank directors nervous



Kansas-Nebraska League of Savings Institutions

Jeffrey D. Sonnich, Vice-President

Suite 512
700 Kansas Avenue
Topeka, Kansas 66603
(913) 232-8215

March 16, 1993

TO: HOUSE JUDICIARY COMMITTEE

FROM: JEFFREY SONNICH, KANSAS-NEBRASKA LEAGUE OF SAVINGS

RE: S.B. 125

Mr. Chairman. Members of the Committee. The Kansas-Nebraska League of Savings Institutions appreciates the opportunity to appear before the House Judiciary Committee in support of S.B. 125 which would define liability for officers and directors of savings and loan associations, commercial banks, and credit unions.

This legislation is an effort to address the problems that resulted from the 1992 United States Court of Appeals decision in FDIC vs. Canfield. 967F. 2nd 443 (10th Circuit 1992). This decision reversed what was believed to be a preemptive Federal law creating a uniform gross negligence standard of conduct for officers and directors of Federally-insured financial institutions. (Financial Institutions Reform, Recovery, and Enforcement Act of 1989 - FIRREA).

The Federal Appeals Court essentially held that the liability statute created by FIRREA permitted simple negligence action against directors and officers in states whose laws permit such actions. Since the general corporate liability defense known as the Business Judgment Rule does not extend to financial institutions, then exposure to simple negligence exists. This was affirmed several years ago in the Kansas Supreme Court decision in FSLIC vs. Huff. (1985).

The provisions of S.B. 125 provide that an officer or director of an insured institution could be held liable for monetary damages for breach of duty of loyalty to the institution, acts of willful or gross and wanton negligent breach of the duty of care, violation of K.S.A. 17-5412, 17-5811 and 17-5812 (attached), or any transaction which derives improper personal benefit. This type of gross negligence provisions supersedes single negligent liability resulting from what is later viewed as mistakes or bad judgment. Executive officers, as defined by the bill, would still be held to a simple negligence standard of liability.

HOUSE JUDICIARY
Attachment #3
03-16-93

Kansas-Nebraska League of Savings Institutions

The passage of S.B. 125 is important in attracting and retaining qualified officers and directors and directly impacts upon the economy and economic development of the State.

It has become increasingly more difficult to secure Board members whose service on a financial institution board would not be governed by the corporate standard.....business judgment rule and good faith reliance on books and records.....but on a simple negligence standard of "thou shalt never make a mistake"! Why should successful business leaders expose themselves or their resources by serving on a financial institution board? The intensity of the attorneys for the RTC in seeking monetary settlements in Kansas has focused this concern within the past year. Community leaders throughout this State are being sued.....not because of fraud, but because of business decisions made during a booming real estate economy.

Further, the absence of an appropriate liability statute has begun to have an adverse impact on the economy. Only the "gold plated" loans or loans made in concert with selected Federal government agencies have become the norm. Why should a financial institution make a loan to a marginal borrower, start-up business, or multi-family housing project when a liability action may be brought in the future because of such decisions? The recent credit crunch is as much a response to legal actions as it is to economic conditions.

We do not support avoidance of fiduciary responsibility and we support the prosecution of fraud, but we do feel it is very important that Kansas have a properly defined liability statute to protect officers and directors of our financial institutions.

We would request that the Judiciary Committee report S.B. 125 favorably for passage.

Jeffrey Sonnich
Vice President

JRT/bw

Encl.

17-5412. Declaration of dividends. The board of directors of any association formed under the provisions of this or any previous act may from time to time declare dividends from the earnings of the association to be paid or credited in such manner as may be provided in the bylaws, but no dividends shall be declared except from the earnings and undivided profits of the association. If the board of directors shall declare, credit or pay any dividend when there is an impairment of capital they shall be jointly and severally liable to the extent of the dividend so declared, credited or paid for all the debts of the association then existing or that shall be thereafter contracted while they shall respectively continue in office. Any of the board of directors who shall object to the declaring of such dividend or the payment or crediting of the same and who shall at the time of declaration of the dividend procure objections to be noted in the book of minutes of the association and shall file a certificate of such objections in writing with the secretary of the association and with the commissioner shall be exempted from such liability and any director of such association who consents to the payment of any dividend when the capital is impaired shall be deemed guilty of a felony and upon conviction thereof shall be imprisoned in the custody of the secretary of corrections for not less than one nor more than five years.

History: L. 1943, ch. 133, § 70; L. 1967, ch. 129, § 2; L. 1990, ch. 309, § 6; May 24.

Article 55.—SAVINGS AND LOAN CODE; POWERS

17-5811. Accepting payments when capital impaired; felony; share defined. No association shall accept or receive payments upon shares when there is an impairment of capital, and any officer, director or employee who shall knowingly violate the provisions of this section or be accessory to or permit or connive at the receiving or accepting payments on such shares, shall be guilty of a felony, and upon conviction thereof shall be punished by imprisonment in the penitentiary not less than one (1) year nor more than five (5) years. The word "share" as used in this section shall not include guarantee shares or stock.

History: L. 1943, ch. 133, § 214; L. 1955, ch. 141, § 11; June 30.

Cross References to Related Sections:

Guarantee shares, see 17-5403, 17-5421 to 17-5428.

Attorney General's Opinions:

Savings and loan associations; preemption of state code by federal law. 83-26.

17-5812. Fraudulent acts; civil liability; felony. Any officer, director, trustee, attorney, agent or servant of any association heretofore or hereafter to be incorporated who shall use or dispose of any part of the moneys, property, assets or funds of such association, or assign, transfer, cancel, deliver up or acknowledge satisfaction of any bond, mortgage or other written instrument belonging to such association, unless duly authorized or otherwise than in the regular and legitimate business of the association, or who shall be guilty of any fraud in the performance of his duties, shall be liable civilly to the association, and also to any other party injured, to the extent of the damage thereby caused, and shall also be guilty of a felony, and upon conviction thereof shall be imprisoned in the penitentiary for not less than one nor more than five years.

History: L. 1943, ch. 133, § 215; July 1.

Source or prior law:

17-1020.

Research and Practice Aids:

Building and Loan Associations ⇔ 23(8).

C.J.S. Building and Loan Associations §§ 14, 15.

CASE ANNOTATIONS

1. On question certified relative to 60-258a, standards of duty on savings and loan association officers discussed. Federal Savings & Loan Ins. Corp. v. Huff, 237 K. 873, 880, 704 P.2d 372 (1985).

Office of Thrift Supervision
Department of the Treasury

Timothy Ryan
Director

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6280

November 18, 1992

TO THE CHIEF EXECUTIVE OFFICER

The Office of Thrift Supervision has become concerned that misperceptions of enforcement actions by federal regulators may be discouraging savings associations from making sound loans and may be deterring qualified individuals from serving on the boards of these institutions.

In order to clarify our views on what we expect of directors and officers of savings institutions, we are today releasing the enclosed Statement Concerning the Responsibilities of Directors and Officers of Insured Depository Institutions. This Statement explains the duties of loyalty and care that directors and officers owe to their institutions.

We hope that this Statement may remove uncertainty that may exist in connection with our enforcement approach to the conduct of directors and officers. I would appreciate it if you would provide a copy of this document to all of your directors and officers.

Sincerely,

Timothy Ryan

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6000

Statement Concerning the Responsibilities of Directors and Officers of Insured Depository Institutions

Representatives of the banking and thrift industries and others have expressed concerns regarding the litigation risks to those who serve as directors or officers of federally insured depository institutions.

This statement addresses this important issue from the standpoint of the Office of Thrift Supervision.

Duties of Directors and Officers

Service as a director or officer of a federally-insured savings institution represents an important business assignment that carries with it commensurate duties and responsibilities.[1]

All thrifts need to be able to attract and to retain experienced and conscientious directors and officers. When an institution becomes troubled, it is especially important that it have the benefit of the advice and direction of business persons whose experience enables them to exercise sound and prudent judgment.

Directors and officers of savings institutions have obligations to discharge duties owed to shareholders and creditors of the institutions they serve, and to comply with federal and state statutes, rules, and regulations. Similar to the responsibilities owed by directors and officers of all business corporations, these duties include the duties of loyalty and care.

The duty of loyalty requires directors and officers to

---

1. The regulatory agencies and others have produced guides that provide useful advice on ways directors can meet their duties to their institutions. These include the Pocket Guide for Directors (FDIC, 1988), The Director's Book (OCC, 1987), and FHLBB, Memorandum No. R 62, reprinted at 52 Fed. Reg. 22,682, 22,683 (1987). See also The Director's Guide: The Role and Responsibilities of a Savings Institution Director (FHLB-SF, 1988).

administer the affairs of the institution with candor, personal honesty and integrity. They are prohibited from advancing their own personal or business interests, or those of others, at the expense of the institution.

The duty of care requires directors and officers to act as prudent and diligent business persons in conducting the affairs of the institution.

This means that directors are responsible for selecting, monitoring, and evaluating competent management; establishing business strategies and policies; monitoring and assessing the progress of business operations; establishing and monitoring adherence to policies and procedures required by statute, regulation, and principles of safety and soundness; and for making business decisions on the basis of fully informed and meaningful deliberation.

Officers are responsible for implementing the policies and business objectives set by the board and for running the day to day operations of the institution consistent with those policies and objectives and in compliance with applicable laws, rules, regulations and the principles of safety and soundness. Directors must require and management must provide the directors with timely and ample information to discharge board responsibilities.

Directors also are responsible for requiring management to respond promptly to supervisory criticisms. Open and honest communication between the board and management of the institution and the regulators is extremely important.

Procedures Followed to Institute Claims

The OTS will not bring civil claims against directors and officers who fulfill their responsibilities, including the duties of loyalty and care, and who make business judgments on a fully informed basis and after proper deliberation.

Claims against directors and officers of thrifts are made following a detailed investigation. Contested claims are asserted only with the concurrence of the Deputy Director for Regional Operations and the Chief Counsel. Suits by the agency are not brought lightly or in haste.

The filing of such claims is authorized only after a rigorous review of the factual circumstances. Preliminary findings and recommendations are subject to review by senior supervisory and legal representatives of the agency.

In most cases, the OTS attempts to alert proposed defendants in advance of filing claims in order to permit them to respond to proposed charges informally and to discuss the prospect of prefiling resolution of the proposed claims.

Nature of Claims Filed

The numerous civil and administrative cases that have been brought in recent years are premised on the established legal principles that govern the conduct of directors and officers.

Claims against former directors and officers of failed savings institutions result from a demonstrated failure to satisfy the duties of loyalty and care. Most claims involve evidence falling into at least one of the following categories:

* Cases where the director or officer engaged in dishonest conduct or approved or condoned abusive transactions with insiders.

* Cases where a director or officer was responsible for the failure of an institution to adhere to its own policies, an agreement with a supervisory authority or where the director or officer otherwise participated in a safety or soundness violation.

* Cases where the director or officer failed to take reasonable steps to respond either to criticisms or directions of the regulatory authority or to advice from professional advisors to the institution.

One factor considered in determining whether to bring an action against a director is the distinction between inside and outside directors. An inside director generally has greater knowledge of and direct day-to-day responsibility for the management of the institution. Inside directors may include, as examples, officers and members of the control group of the institution.

By contrast, outside directors generally do not participate in the conduct of the day-to-day business operations of the institution. The most common claims brought against outside directors either involve insider abuse or situations where the directors were on notice of circumstances existing at the institution that required correction and failed to take steps to implement corrective measures after receiving such notice.

###

The Top 40

Who's hot and what's hot in the entertainment business

September 28, 1992 Four Dollars

Forbes

THE SAVINGS & LOAN MESS

MAKING THE WRONG PEOPLE PAY

39

0 439338 2

Attachment #3 — 8
03-16-93

In the name of recovering money for the taxpayer, two government agencies are destroying the livelihoods of innocent people and scaring bankers into closing their loan windows.

What did pop expect to happen when he gave the kid his credit card?

By Gretchen Morgenson

RICHARD BLAIR, 69, a lawyer who lives in McLean, Va., was much like the other outside members on the board of McLean Savings & Loan, a medium-size Virginia thrift. He was chosen for the position because of his local prominence and business connections. In 1975 he joined a retired army general, a newsletter editor, a book publisher and a psychiatrist on the board, along with several of the bank's managers.

Late one Friday afternoon in July 1988 the Federal Deposit Insurance Corp. stormed McLean's headquarters—making sure that a local television news crew was there to record the event—and locked the doors. The thrift failed. McLean had lost millions through a mortgage subsidiary that wrote too many home loans in Texas.

Thus began an ordeal for Blair and his family.

To recover some of the money the government lost in paying off McLean's depositors, the FDIC sued the S&L's officers and directors, alleging breach of fiduciary duty and gross negligence in loan practices. Blair was amazed to find himself a defendant. He had even voted no on one of the loans that the government said was negligently made. Even more shocking: For most of the time that the allegedly negligent lending had taken place, Blair had been lying comatose in a hospital bed.

All three magistrates in the Eastern District of Virginia that have presided over the McLean case at various times

Attachment #3 -- 9
03-16-93

Standing, left to right: Richard Blair, John Harn II, Major General Lloyd Ramsey, Marshall McClean, Harvey Cohen, Robert Goldsten, John Harrison, Sandra Hughes, Thomas Leonard III; kneeling: Frank Howard, Vincent Callahan Jr., Jack Wuerker, Jonathan Schraub
McLean S&L's board and lawyers have won two battles against the FDIC. But not the war.

have criticized the FDIC for improper conduct or for failure to follow rules or prior court orders. The last judge ordered the agency to pay $6,600 in court, transcript and deposition costs because the FDIC's case was abusive.

Still, the FDIC presses on, regardless of cost and regardless of the merits of its case. This is a government agency utterly out of control, terrorizing innocent bystanders and frequently costing the taxpayers far more in legal fees than it is recovering.

To date, the FDIC has spent an estimated $10 million on its case against the Virginia thrift's officers and directors. The defendants have spent about $1 million. Recovery to the FDIC: $40,000 so far, from two officers settling immediately for $20,000 each. Most of the other defendants, including Blair, are still fighting. The legal bills will continue, since the FDIC is appealing yet again.

Why this miscarriage of justice, this waste of taxpayer money? Because the private law firms that have been hired to recover money lost in bank and thrift failures are billing by the hour for their services. They have no real incentive to settle cases and every incentive to drag them on.

No matter how absurd their claims, or how little the prospect for a recovery, they can bill the taxpayers for their time on these professional liability cases, at $200 an hour and up. Total costs? Well over $100 million of the FDIC and Resolution Trust Corp.'s legal budget, which comes to a combined $1 billion this year for outside law firms. (Much of the rest is for routine collections and foreclosures.)

No one knows how much the defendants are spending fighting the professional liability cases, but it is enough to break many of them financially. And the defendants are not all Charles Keating types who cynically bilked unsuspecting people. Plenty of them are honest citizens whose connection to the events was peripheral.

This is the S&L crisis, part II. In part I, the federal government in effect lent out its own capital by providing an all but unlimited guarantee of deposits and allowing the deposit takers to speculate with the money. As it turned out, this was equivalent to giving your 14-year-old kid your American Express card and telling him to go out and

Attachment #3 — 10
03-16-93

Candice Brown, a student at Oregon State University
Of the government's $28 million case against her late father: "I know we'll win. But it's a struggle."

have a good time.

The payoff was that the federal government expects to lose $300 billion (not counting future interest payments) in making good the credit card charges. In part II, the government looks for scapegoats. Instead of blaming itself for letting the kid have the card, it tries to pin the blame on the merchants who sold stuff to the kid. With its band of legal mercenaries, the two government agencies responsible for closing more than 2,100 institutions that have failed so far are suing accountants, lawyers, neighborhood real estate appraisers and anyone else remotely connected to a sick thrift or bank.

The worst that many of these folks can be accused of is taking a businessman's risk, voting yes on a loan that looked solid but that later failed, not because of fraud or wrongdoing, but because of an economic downturn.

Lawrence Brown was a well-respected real estate appraiser in Medford, Ore. In the early 1980s Brown appraised the value of six apartment complexes in California for a subsidiary of Pacific Savings Bank. In 1989 Pacific failed; when the FDIC closed it down, the agency sued a group of 20 officers, directors and associated professionals for $70 million.

Brown was included in the suit for allegedly overvaluing the properties in his six appraisals. Never mind that four of the six appraisals were made months and in one case more than a year *after* Pacific had financed the properties, so that Brown's appraisals had nothing to do with the bank's decision to make these loans. Brown was sued for $28 million, $3 million more than the value of the properties he had appraised.

Brown died two years ago in a farming accident at the age of 52. His insurer has had to pay $400,000 in legal bills. In 1991, after two years of litigation, a U.S. district court judge in California threw out the case, ruling that the FDIC's law firm, Tuttle & Taylor of Los Angeles, had never proved that the appraisals it said were negligently prepared by Brown were prepared by him at all.

Not to be stopped, the agency has appealed the judge's decision. Meanwhile, its $28 million in claims against Brown's estate has effectively locked up what remains of his assets, about $1.5 million. Thanks to this regulatory extortion, Brown's daughter Candice, in her junior year at Oregon State University, is having trouble paying her college bills. "It was hard enough when my dad was alive. Now he's not even here to defend himself," she says.

Cost to the FDIC of six lawyers and three paralegals in the Brown case: about $400,000, with more to come. Cost to the defendant: $400,000. Recovery to the taxpayer: zero.

Torquemada, updated. The Bill of Rights gives procedural protections to criminal defendants, but it doesn't protect the innocent against financial ruin from lawyers' bills.

Lincoln Savings & Loan Association, not to be confused with Keating's Lincoln S&L, was a solvent thrift in Miami Beach owned by a group of local businessmen. In 1984 they sold Lincoln to a cadre of Texas investors. Unfortunately, these folks didn't know much about the S&L business; Lincoln failed in 1989.

Earlier this year the RTC sued the entire 1984 board of Lincoln for selling it to the Texas folks. The government's claim? The board should have known Lincoln's buyers would run it into the ground five years after they bought the thrift. It is almost comical that the RTC is pursuing Lincoln's directors and officers in spite of the fact that the federal government itself approved the thrift's sale to the Texas investors. The RTC is even suing Fred Rizk, an advisory director to the Texas owners who never voted on bank matters. Oddly, the RTC is suing only one other member of Lincoln's board, letting the other Texas directors off the hook.

Who's funding this witch-hunt? You are, the taxpayers. Any money spent on outside lawyers pursuing ridiculous cases reduces the net amount the government collects by liquidating the assets of failed banks and thrifts, and thus increases the taxpayers' or, in the case of the FDIC, the bank depositors' outlays needed to bail out the industry.

The defense costs are in the first instance borne by individuals and some insurance companies. But in the long run those costs spread into the economy as a whole. The threat of litigation has a lot to do with the disastrous drop

Attachment #3 — 11
03-16-93

RTC acting general counsel Richard Aboussie
Escalating legal costs don't seem to trouble him. "You've got to spend money to develop cases."

son & Hecker withdrew its settlement offer and began legal proceedings against Henkel. Soon after his lawyers brought the government's egregious turnabout to light, the proceedings were quietly settled.

Another abusive tactic: changing the venue in a lawsuit. In a case alleging "undue enrichment" involving Heritage Bank, a California institution that failed in 1983, the FDIC filed suit in state court to recover some $200,000 in money advanced to Heritage customers. The case dragged on for years and was about to be dismissed in early 1988, when the FDIC brought a new suit in federal court. Having spent five years and hundreds of thousands of dollars litigating in state court, the defendants now have to fight the FDIC all over again in federal court.

FDIC lawyer Byrne claims his operation is cost-effective, taking in $2.50 in cash or in judgments "highly likely to be collected" for every dollar spent. The folks at the RTC can't say what their recovery ratio is; Ira Parker, associate general counsel for litigation, says: "You can't expect our recoveries to be as high as the FDIC's," because the agency's upfront expenses have been high and recoveries come later.

Unfortunately for the folks ultimately paying these bills, the FDIC's 2.5-to-1 recovery ratio is highly suspect. Here are just two examples, turned up in a review of a handful of cases. In papers filed by the FDIC to close a receivership in a Wisconsin bank, the government says it recovered $303,000 in a directors' and officers' liability claim. But the FDIC has not received a dime, according to the only lawyer defending the directors and officers in the case. And in the McLean suit, the FDIC listed in its papers a $250,000 "likely-to-be-recovered" settlement. In fact, the settlement was for a range of $30,000 to $250,000, based on a percentage of the defendant's annual income in a given year, and the high-end figure is unlikely to be recovered. The defendant, a small-town physician, would have to make $1 million in income during the year to cough up that settlement. So far, no money has changed hands.

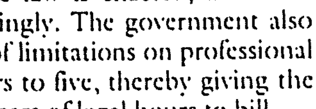
As for the expense side of the balance sheet: When the RTC figures its recoveries against its costs, it includes only outside counsel fees, not internal RTC lawyer or investigatory costs. And where the FDIC is concerned, litigation costs are understated because they are often billed to the failed institution itself rather than to the FDIC.

And so, even as litigation costs are skyrocketing, the chances of the government's recovering cash are declining. The single biggest source of liability case recoveries is the insurance industry, accounting for 95% of recoveries received by the FDIC between 1989 and 1991. But this fountain of funds is drying up. Fewer failed institutions have insurance coverage today than had it in the past. What's more, the so-called regulatory exemption, which lets an insurer off the hook if a regulatory agency sues a director or officer of a failed institution, is now a feature in almost all directors' and officers' insurance policies and has been deemed enforceable by nine out of ten appellate courts across the U.S.

The FDIC supports pending legislation that could make this exemption illegal. If the law is enacted, insurance premiums will go up accordingly. The government also wants to extend the statute of limitations on professional liability cases from three years to five, thereby giving the freelance lawyers two more years of legal hours to bill.

The real villains of the great S&L escapade—the likes of Charles Keating, Vernon S&L's Don Dixon and Centrust's David Paul—are, thankfully, behind bars and facing huge civil lawsuits. Michael Milken, who may or may not have caused some thrifts to buy bonds that subsequently went bad, has coughed up a $400 million restitution fund, a sizable chunk of which is likely to end up with the RTC and FDIC. But crooks account for only a fraction of the money lost, and junk bonds for almost none.

It's time for Congress to call off this witch-hunt and face up to its own responsibility in causing the disaster. What did Congress think would happen when it handed Uncle Sam's credit cards to a lot of people and didn't put proper restrictions on how they used them? ■



Attachment #3 - 12
03-16-93

in bank lending that has added to the severity of the recession. Commercial loans outstanding in March totaled $552 billion, $54 billion below the total a year earlier.

In part because the RTC has terrorized everyone, small businesses, which created much of the growth of the 1980s, can no longer get financing to expand their operations. According to the National Federation of Independent Business, the fraction of firms borrowing on a regular basis today has fallen to 34%, from 41% ten years ago. Says Timothy Harris, a Los Angeles lawyer defending the estate of the Oregon appraiser: "The FDIC's eagerness to sue has made the threat of possible litigation a silent partner in every loan decision made in the U.S."

Caseloads at both bailout agencies are exploding. Of the more than 200 professional liability cases at the RTC, half were filed in the first six months of this year; another 240 are expected over the next few years. The FDIC has about 300 of these claims pending and more coming. Pending RTC cases against accounting firms seek more than $1.4 billion in damages.

This little growth industry extends into other arms of the government as well: The RTC is now a major employer of FBI agents who don't have enough counterintelligence work to keep them busy.

How do the FDIC and RTC justify their cause? "The FDIC has a statutory and fiduciary duty to the American people to maximize recovery," orates FDIC general counsel Alfred Byrne III. He insists: "We do not file suit for mistaken, ill-formed business judgment."

FDIC general counsel Alfred Byrne III
Now a silent partner in every loan decision made in the U.S.

Oh no? To hear the government talk about the S&L losses, you'd think they were all a result of massive fraud and misdealings. The RTC claims that 81% of S&L failures involved fraud or wrongdoing. That simply isn't so. Many of the government's cases boil down to what Victor Simon, a lawyer and editor of *Bank Bailout Litigation News* in Washington, D.C., calls 20-20 hindsight. Says Simon, "If members of Congress who make our banking laws don't have a clue about how banks work, why should outside directors?"

The staffs at the FDIC and RTC say they closely monitor outside firms' expenses. But the fact remains that outside law firms have but one incentive: to keep on billing.

Even before its cases get to trial, the FDIC and RTC seem more interested in litigating than in settling. The FDIC says settlement discussions always take place prior to suits' being filed today; this was not the case a year and a half ago. At the RTC, such talks are only a "general practice." One target of a professional liability suit, who fears retribution if he is identified, says he was never invited to a prelitigation discussion before the RTC sued him for over $1 million.

Other stories emerge of settlements offered, only to be rejected by the government. Minneapolis lawyer Susan Barnes is defending a $5 million case, involving a Wisconsin bank, in which the insurer for one of the directors offered a settlement of $325,000. Even though its chances of getting more out of the defendant were slim, the FDIC rejected the offer and continued to litigate.

This, in spite of the fact that the insurer had won its case in two venues. Both judges ruled against the FDIC because the insurance policy carried a clause nullifying coverage if the director is sued by a regulatory agency. Still, to avoid more legal bills, the insurer offered to settle. The director has no other assets that the FDIC could get its hands on. No matter, the case is pending in appellate court in Wisconsin; it is highly likely the government will lose it. The defendant's cost of litigating the case so far is an estimated $150,000. The FDIC's costs are probably greater.

The government's tactics aren't merely impractical, they are abusive. One is to convince a defendant in a suit to provide information the government needs in return for promising to drop the defendant's name from the suit; then the government sues him or her anyway.

Morrison & Hecker, the Kansas City-based law firm that is getting rich litigating the RTC's case against Charles Keating—it earned $11 million from the RTC last year alone—used this trick on Lee Henkel Jr., the former head of the Federal Home Loan Bank Board and a lawyer involved in the Keating case.

In May 1990 Henkel was named as a defendant in Shields v. Keating, the securities law case Keating lost this past year. In January 1991 Henkel was told by Morrison & Hecker that if he helped the RTC in its case against Keating, it would advise the government to settle his case and not sue him further. Henkel agreed to the proposal and provided information to the RTC late that month.

Three weeks later, having gotten what it wanted, Morri-

Attachment #3 — 13
03-16-93

TESTIMONY ON SB 125

AN ACT concerning liability of officers and directors of certain financial institutions

Presented to the
HOUSE JUDICIARY COMMITTEE

MARCH 16, 1993

by the

KANSAS CREDIT UNION ASSOCIATION

Mr. Chairman, members of the Committee:

I am Jerel Wright, Governmental Affairs Director of the Kansas Credit Union Association. Our association enjoys the voluntary membership of all but 3 of the 177 credit unions in Kansas. The Kansas credit unions support passage of Senate Bill 125.

Directors of Kansas credit unions have limited immunity from liability under K.S.A. 1992 Supp. 60-3601 (attached) which grants immunity from liability to volunteers of nonprofit organizations (as defined under 501(c) of the Internal Revenue Code). Credit unions are chartered and regulated as 501(c)(14)(a) nonprofit organizations. Credit union directors qualify as volunteers under K.S.A. 1992 Supp. 60-3601 since they serve without receiving direct or indirect compensation. Directors are elected by the members of each credit union during the credit union's annual meeting.

In 1987, when the Kansas legislature adopted the volunteer immunity statute, Kansas credit unions were very encouraged because potential volunteers became less sensitive about the idea of personal liability for service as a volunteer. The statute went a long way toward relieving apprehension over volunteering as a credit union director.

Credit unions support SB 125 as an effort to codify and clarify the liability of directors for breach of fidiciary duty as directors of Kansas credit unions. The bill clearly establishes, in credit union law, the standard under which a director may be held personally liable for an action or failure to act.

Mr. Chairman, I stand for any questions at your direction.

HOUSE JUDICIARY
Attachment #4
03-16-93

REMARKS PRESENTED TO THE

HOUSE JUDICIARY COMMITTEE

IN SUPPORT OF S.B. 125

BY WILLIAM R. SAMPSON

FOR THE KANSAS ASSOCIATION OF DEFENSE COUNSEL

MARCH 16, 1993

Kansas Association of Defense Counsel / 627 SW Topeka / Topeka, Kansas 66603

HOUSE JUDICIARY
Attachment #5
03-16-93

We all have heroes. Heroes are essential to us. They excite us; they inspire us.

They help us become better people, ourselves.

When I was a boy, my heroes were sports figures -- Mickey Mantle and Johnny Unitas.

Later, as a college student, I greatly admired Jim Pearson, our Kansas Senator, and Bobby Kennedy.

Still later, when I was serving on active duty with the United States Navy, my hero was Admiral William Lawrence, a former prisoner of war, who returned to the United States and, for a short time, was my commanding officer.

Since law school, my heroes have been closer to home-- and have included the great lawyers of Kansas and the great business leaders of this state . . .

- The people who create our jobs,
- The people who enable our businesses to compete and succeed,
- The people who resolve our disputes, peacefully and with fairness.

In recent years, this country has suffered through what is called "the savings and loan crisis."

We have all heard of selfish, dishonest people who have dominated some of our nation's largest financial institutions, bleeding them of their assets and hanging them out to dry.

We know the enormous cost to our nation of these failures.

But for every person who paid himself millions while he pillaged his community savings and loan there were countless others who did not.

In Kansas, these people were our community's finest leaders -- from the standpoint of integrity as well as success, our best and our brightest -- giving selflessly of their time and experience so that Kansans in Arkansas City, Parsons, Coffeyville, Hutchinson, Liberal, Wichita, and elsewhere could borrow money to buy a home.

You know these people. In many instances, their names are truly household words in Kansas.

The lawyers and law firms are known to anyone who has ever held a volume of the Kansas Reports.

They are your neighbors, your doctors, your defenders, your friends.

Instead of getting millions, these Kansans got maybe a hundred dollars a year for serving on these boards.

They showed up for the meetings.

They did their best.

There was never a self-serving thought, much less an action.

What they could do -- and did -- was serve their institutions and their communities honorably and well.

What they could not do -- in the face of a collapsing real estate and financial market nationwide -- was save all of these institutions. Regretably, many failed.

We are now embarked upon the greatest witch hunt since Joe McCarthy. The RTC, using its immense power and inexhaustible resources, relentlessly pursues these men and women who have given their professional lives to support their communities.

Its tactic is familiar -- to threaten each and every one of them with financial ruin and then shake as much money out of them as possible in settlements. The RTC can do this because the existing standard of care makes it impossible for anyone to escape short of ruinous discovery and trial.

We come before you today for help . . . help in the form of Senate Bill 125, amended so that its benefits apply to the Kansas leaders who have already been sued as well as those who have not.

Approving this legislation will not sanction criminal conduct in Kansas.

It will not forgive fraud.

It will not overlook outrageous behavior.

But it will provide appropriate protection for those who served when called;

It will protect them from the glare of 20/20 hindsight;

And it will put Kansas in line with the strong majority of other states whose legislatures have acted.

We therefore ask you to amend Senate Bill 125 to apply it to your community leaders who are now being sued for everything that they own.

We ask you to amend it, pass it, and send it to the governor.

Thank you.

10701825

AMENDMENT TO SENATE BILL 125
PROPOSED BY THE KANSAS ASSOCIATION OF DEFENSE COUNSEL

Sec. 4. This act shall be applicable to all actions filed by a receiver or conservator, including without limitation actions brought pursuant to 12 U.S.C. 1821(k), regardless of the date of filing.

Sec. 5. This act shall take effect and be in force from and after its publication in the Kansas register.

March 16, 1993

Kansas Association of Defense Counsel / 627 SW Topeka / Topeka, Kansas 66603

SENATE BILL 125

BACKGROUND

THE BILL

Senate Bill 125 [Attached as Appendix I] sets an easily understood, uniform standard of liability applicable to officers and directors of financial institutions. It sets a standard of liability which would allow responsible community members to serve on the board of directors of financial institutions, and provide them with sufficient latitude to exercise their best judgment in governing these institutions; while at the same time discouraging self-dealing, breaches of loyalty, fraud, willful or gross or wanton negligence.

LEGAL CONTEXT

Historically, the standard of care applied to officers and directors of financial institutions was gross negligence. In the absence of a showing of gross negligence, or intentional self-dealings, directors of financial institutions were not liable for losses sustained by the institution.[1] The general concept was often referred to as the "business judgment" rule.

Business people are required to make decisions combining careful analysis with some risk-taking. Often, much time passes before the ramifications of such risk-taking are clear or the impact felt. Even the most prudent business leaders, from time to time, must engage in risk-based undertakings. Directors must have latitude to decide difficult questions at the

---

1 James Hacks, Jr., "Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification," 43 The Business Lawyer 1207 (1988).

time they arise. The traditional rules allowed this freedom.

Beginning in the mid-1980's, a few courts began to play a more activist role in second-guessing the decisions made by corporate and financial institution boards of directors. Some courts began to apply a "simple" negligence standard to director's conduct.

This trend has had long term consequences. Director and officer liability insurance has become difficult or impossible to obtain. When available, it is often cost prohibitive. Responsible individuals have become more reluctant to serve on boards. These trends have been exacerbated by litigation generated as a result of the saving and loan crises.

In response, legislatures across the country have begun to address these problems. Since 1985, more than four-fifths of the states have enacted legislation designed to protect directors from money damages.[2] The approaches varied. Many states passed legislation, similar to Senate Bill 125, setting a willful and wanton or gross negligence standard [See examples in Appendix IV]. Other states, including Kansas, passed laws allowing companies through their articles of incorporation to limit liability of directors to a breach of loyalty, self-dealing, or knowing misconduct.

The predominant national standard remains gross negligence. As a consequence of legislation and court decisions, however, there is a hodgepodge of different standards applicable to directors in a single state as well as to directors in different states.

As a further complication to the mix, in 1989, Congress, in response to the savings and loan crises, passed the Financial Institutions Reform, Recovery and Enforcement Act

---

[2] Douglas M. Branson, "Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors," 57 Fordham L. Rev. 375 (1988).

of 1989 (FIRREA). FIRREA provides a director or officer of a financial corporation may be held personally liable "for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State Law." [See Appendix II, 12 U.S.C.A. 1821 (k).] Some courts and commentators have suggested this language was meant to set a single national standard for suits brought against officers and directors of financial institutions. Other courts and commentators have suggested the federal standard was meant to be in addition to any state standards.[3]

THE PROBLEM

Legislation aimed at setting a standard of liability for officers and directors of financial institutions needs to strike a careful balance. On one hand, it should discourage or prohibit conduct such as self-dealing, fraud, willful or gross and wanton negligence.

On the other hand, it should encourage, or at least not discourage, responsible people from serving on boards. In addition, it should provide directors the necessary freedom to effectively manage their organizations. Finally, it should aim at uniformity.

It is a fact of recent corporate life that when faced with difficult or sensitive issues, directors are often subject to suit, irrespective of the decisions they make. Many of the most important decisions directors are asked to make are not easily susceptible to right or wrong analysis at the time they are made; they are exercises in discretion. Often, a better

---

[3] David B. Fischer, "Bank Director Liability under FIRREA: A New Defense for Directors and Officers of Insolvent Depository Institutions - or a Tighter Noose?", 39 UCLA Law Review 1703 (1992).

result may appear, especially with hindsight, to have been attainable, but that conclusion does not necessarily mean a director's decision was wrong when made.

A "simple" negligence standard judges people on hindsight. It may make directors fearful of having their decisions second guessed years later and, as a result, cause them to become wary, reluctant, ineffective.

Perhaps more important, there is a need to attract and retain bright ambitious community leaders to serve as officers and directors. Absent legislation such as Senate Bill 125, the risk has become too great. Given the risk, no reasonable attorney would advise his client to accept, and no responsible person would accept an offer to become a financial institution director.

We should not have a system which discourages honest, responsible persons with assets to protect from being directors of financial institutions at a time when the need for such individuals is great. In the words of Judge Learned Hand, "The law ought not make trusteeship so hazardous that responsible individuals will shy away from it."

THE SOLUTION

Senate Bill 125 goes a long way toward striking the necessary balance. It provides a remedy for wrongdoing, while allowing a measure of protection for conscientious individuals confronted with complex decisions. It clarifies prior Kansas case law. It conforms to the federal "gross" negligence standard and is consistent with the law of a majority of other states.

The bill, as passed by the Senate is clearly a step in the right direction. The bill could be strengthened, however, by making it effective upon passage and applicable to all actions filed pursuant to 12 U.S.C. 1821 (k).

As a result of the savings and loan crises and the passage of FIRREA, the Resolution Trust Corporation (RTC) has filed multiple suits against former savings and loan directors, and no doubt many more will be filed. Although FIRREA specifically references a "gross" negligence standard, the RTC frequently makes claims based on "simple" negligence as well.

Passage of Senate Bill 125 in its present form would eliminate claims based on simple negligence filed after the date of passage. It would also, unfortunately, result in different standards being applied to conduct that occurred during the same time frame.

Most of the suits filed by the RTC involve corporate decisions made in the time period from 1983 to 1985. Many of these suits have been filed in the past year, and it is anticipated that many more will be filed in the coming year.

The passage of Senate Bill 125 in its present form would mean, for example, that a claim based on a board of director's decision in October of 1984 would arguably be subject to a simple negligence standard, if the suit is already on file. The same conduct occurring in October 1984 would be subject to a "gross" negligence standard if the claim was made as part of a suit yet to be filed.[4] In order to avoid this kind of inconsistency this past session of the Oklahoma Legislature passed a bill adopting a gross negligence standard and making it applicable to any claim or action filed after August 9, 1989, the effective date of FIRREA. [See Appendix III, Okla. Stat. Ann., tit. 6 §712]. A similar bill is pending before

---

[4] As a result of the application of the doctrine of "adverse domination", the date of the filing of a suit by the RTC often bears little relationship to the date of the claimed misconduct.

the Texas legislature. [See Appendix V]. Senate Bill 125 should be amended to achieve the same result.

Senate Bill 125 is a welcome step toward uniformity. It would apply the same standard to state and nationally charted banks. It would clarify Kansas case law as to the standard of proof applicable to claims against officers and directors of financial institutions. It would conform to the federal "gross" negligence standard set forth in FIRREA. It is consistent with the law of a majority of other states. The proposed amendment would be a further step in the right direction. It would apply a uniform standard to conduct occurring during the given time frame.

APPENDICES

APPENDIX I:	Kansas Senate Bill No. 125
APPENDIX II:	The Federal Standard, 12 U.S.C.A. 1821(k)
APPENDIX III:	Okla. Stat. Ann., tit. 6 §712
APPENDIX IV:	Selected Statutes from other states.
	A. Fla. Stat. Ann. §607.0830
	B. Ind. Code Ann. §23-1-35-1
	C. Me. Rev. Stat. Ann. tit. 13-A §716
	D. Ohio Rev. Code Ann. §1701.59
	E. Wis. Stat. Ann. §180.0828
APPENDIX V:	Proposed Texas Statute
APPENDIX VI:	Proposed Nebraska Statute

Attachment #5 14
03-16-93

SUPPLEMENTAL NOTE ON SENATE BILL NO. 125

As Amended by Senate Committee on Judiciary

Brief*

S.B. 125 provides immunity from personal liability of officers and directors of state and national banks, and state and federal savings and loan institutions and credit unions except for the following:

1. executive officers;

2. breach of a duty of loyalty;

3. willful or gross and wanton negligent breach of their duty of care;

4. violations of laws regulating declaration of dividends and capital impairment and fraud; and

5. acts involving improper personal benefit.

The bill also defines "executive officer" in reference to each of the three financial institutions covered.

Background

The bill was supported by the Kansas Bankers Association, the Kansas-Nebraska Savings and Loan League, the Kansas Credit Union League, and others. Proponents said a recent decision of the U.S. Court of Appeals, *FDIC v Canfield* 967 F2d 443 (1992) made it possible to collect damages against officers and

---

* Supplemental Notes are prepared by the Legislative Research Department and do not express legislative intent.

5345/mh

As Amended by Senate Committee

Attachment #5 — 15
03-16-93

Session of 1993

SENATE BILL No. 125

By Committee on Judiciary

1-29

AN ACT concerning liability of officers and directors of certain financial institutions.

Be it enacted by the Legislature of the State of Kansas:

Section 1. ~~An~~ *Except for persons who are executive officers, an* officer or director of a bank or national banking association shall have no personal liability to the bank, association or its stockholders~~, or any other person,~~ for monetary damages for breach of duty as an officer or director, except that such liability shall not be eliminated for: (a) Any breach of the officer's or director's duty of loyalty to the bank, association or its stockholders; (b) acts or omissions which constitute willful or gross and wanton negligent breach of the officer's or director's duty of care; (c) acts in violation of K.S.A. 9-910, 9-911 or 9-912 and amendments thereto; or (d) any transaction from which the officer or director derived an improper personal benefit~~, except that the monetary liability shall not exceed the amount of such benefit~~. *For purposes of this section, "executive officer" means the chairperson of the board, the president, each vice president, the cashier, the secretary and the treasurer of a bank or national banking association, unless such officer is excluded by resolution of the board of directors or by the bylaws of the bank or national banking association from participation in the policymaking functions of the bank or national banking association, and the officer does not actually participate in the policymaking functions of the bank or national banking association.*

Sec. 2. ~~An~~ *Except for persons who are executive officers, an* officer or director of a savings and loan association, federal savings association or federal savings bank shall have no personal liability to the savings and loan association, federal savings association or federal savings bank or its members or stockholders~~, or any other person,~~ for monetary damages for breach of duty as an officer or director, except that such liability shall not be eliminated for: (a) Any breach of the officer's or director's duty of loyalty to the association or bank, its members or stockholders; (b) acts or omissions which constitute willful or gross and wanton negligent breach of the officer's or di-

directors of national banks for simple negligence whereas under the Kansas Corporation Code which applies to state chartered banks liability of directors and others may be limited under K.S.A. 17-6002(b)(8).

The Kansas Trial Lawyers Association opposed the bill.

Attachment #5 — 16
03-16-93

rector's duty of care; (c) acts in violation of K.S.A. *17-5412,* 17-5811 and 17-5812 and amendments thereto; or (d) any transaction from which the officer or director derived an improper personal benefit~~, except that the monetary liability shall not exceed the amount of such benefit~~. *For purposes of this section, "executive officer" means the chairperson of the board, the president, each vice president, the cashier, the secretary and the treasurer of a savings and loan association, federal savings association or federal savings bank, unless such officer is excluded by resolution of the board of directors or by the bylaws of the savings and loan association, federal savings association or federal savings bank from participation in the policymaking functions of the savings and loan association, federal savings association or federal savings bank, and the officer does not actually participate in the policymaking functions of the savings and loan association, federal savings association or federal savings bank.*

Sec. 3. ~~An~~ *Except for persons who are executive officers, an* officer or director of a credit union *or federal credit union* shall have no personal liability to the credit union *or federal credit union* or its members~~, or any other person,~~ for monetary damages for breach of duty as an officer or director, except that such liability shall not be eliminated for: (a) Any breach of the officer's or director's duty of loyalty to the credit union or its members; (b) acts or omissions which constitute willful or gross and wanton negligent breach of the officer's or director's duty of care; (c) acts in violation of K.S.A. 17-2209 and amendments thereto; or (d) any transaction from which the officer or director derived an improper personal benefit~~, except that the monetary liability shall not exceed the amount of such benefit~~. *For purposes of this section, "executive officer" means the chairperson of the board, the president, each vice president, the cashier, the secretary and the treasurer of a credit union or federal credit union, unless such officer is excluded by resolution of the board of directors or by the bylaws of the credit union or federal credit union from participation in the policymaking functions of the credit union or federal credit union, and the officer does not actually participate in the policymaking functions of the credit union or federal credit union.*

Sec. 4. This act shall take effect and be in force from and after its publication in the Kansas register.

ɔlish procedures and
: effects caused by its
munity.

ıf Federal law or the
ɛ method which the
espect to an insured
ger of default, includ-
ion (n) of this section
ction shall govern the
d depositors) of such

on, acting as receiver
aving a claim against
institution for which
: amount such claim-
ɔn had liquidated the
vithout exercising the
(n) of this section or

ion and in the inter-
vn resources to make
ional amounts to or
of any claimant or
ion shall not be obli-
ny such payment or
respect to or for the
ɔf claimants, to make
ategory or claimants.

ult is a Bank Insur-
may only make such
ank Insurance Fund.
is a Savings Associa-
ɔrporation may only
held in the Savings

(C) Manner of payment

The Corporation may make the payments or credit the amounts specified in subparagraphs (A) and (B) directly to the claimants or may make such payments or credit such amounts to an open insured depository institution to induce such institution to accept liability for such claims.

(j) Limitation on court action

Except as provided in this section, no court may take any action, except at the request of the Board of Directors by regulation or order, to restrain or affect the exercise of powers or functions of the Corporation as a conservator or a receiver.

(k) Liability of directors and officers

A director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by, on behalf of, or at the request or direction of the Corporation, which action is prosecuted wholly or partially for the benefit of the Corporation—

(1) acting as conservator or receiver of such institution,

(2) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed by such receiver or conservator, or

(3) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed in whole or in part by an insured depository institution or its affiliate in connection with assistance provided under section 1823 of this title,

for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.

(*l*) Damages

In any proceeding related to any claim against an insured depository institution's director, officer, employee, agent, attorney, accountant, appraiser, or any other party employed by or providing services to an insured depository institution, recoverable damages determined to result from the improvident or otherwise improper use or investment of any insured depository institution's assets shall include principal losses and appropriate interest.

ıy final order of the Banking Board shall be appealable of Section 207 of this title.

5, § 4, operative July 1, 1987. Amended by Laws 1986, c. 24, 1986; Laws 1987, c. 135, § 8, eff. July 1, 1987; Laws ff. May 24, 1989.

RTICLE VI. CLOSING DAYS

ne business day weekly in addition to holi-

ce banks, national banks, federal reserve banks, federal and state savings and loan associations, federal credit d state credit unions, may fully dispense with, or restrict determine, the hours within which it will be open for ss day of each week, in addition to any other legal holiday l Columbus Day on the second Monday in October. Any h organization may be changed by it from time to time in :horized, required or permitted to be performed at or by n or credit union on a business day when such bank, is so closed may be performed on the next succeeding ity or loss of rights of any kind shall result from such

316, § 5, emerg. eff. June 24, 1986.

ATE FUNCTIONS, BANKS AND TRUST COMPANIES

Laws 1984, c. 133, § 10, eff. Oct. 1, 1984

Laws 1984, c. 133, § 10, eff. Oct. 1, 1984

ɔreferred shareholders—Dividends—Voting sion rights

standing any other provision of law, whether related to of dividends upon capital stock or otherwise, the holders entitled to receive cumulative dividends.

n stock may not be paid until dividends on preferred stock nt. No dividends shall be declared or paid on common dividends on the preferred stock shall have been paid in :ompany is placed in voluntary or involuntary liquidation, to the holders of common stock until the holders of been paid in full the par value or the retirement price ıch stock plus all accumulated dividends.

ersion—Retirement. Preferred stock shall have such :s and such control of management, and shall be subject and in such manner and upon such conditions, as may be ɪf incorporation or any amendment thereto, with the

133, § 6, eff. Oct. 1, 1984.

l officers—Banks and trust companies

nk or trust company shall be managed by a board of se its powers and be responsible for the discharge of its ectors, not less than five (5) nor more than twenty-five he bylaws and the number so fixed shall be the board t least three-fourths of the directors shall be citizens of

Oklahoma Statutes

the United States, two-thirds shall be residents of this state and a majority shall reside within one hundred (100) miles of the place of business of the bank. Directors need not be stockholders of the bank or trust company unless so required by the bylaws of the bank or trust company. A director who is disqualified shall be removed by the board of directors or by the Commissioner. No action taken by a director prior to resignation or removal shall be subject to attack on the ground of his disqualification.

B. Directors shall receive such reasonable compensation as the bylaws may prescribe and shall serve until their successors are elected and qualify.

C. Directors shall be elected by the stockholders at the first meeting and thereafter at the annual meeting or at a special meeting called for the purpose. If the articles of incorporation or amendments thereto provide for cumulative voting, the votes of each share may be cast for one person or divided among two or more, as the stockholder may choose. The person or persons (to the number of directors to be elected) having the largest number of votes shall be elected.

D. The terms of office of directors shall be one (1) year. Vacancies may be filled by vote of the board of directors until the next meeting of the stockholders.

E. A director may be removed by the stockholders at a meeting. Where cumulative voting for directors is provided in the articles of incorporation or amendment thereto, no director shall be removed unless the votes cast against a motion for his removal are less than the total number of shares outstanding divided by the number of authorized directors, but all of the directors shall be removed if a majority of the outstanding shares approves a motion for the removal of all.

F. The officers designated by the bylaws shall be elected by the board of directors. The president and managing officer shall be members of the board of directors. The president may also serve as managing officer. No officer shall be elected or a contract executed for his employment for a period longer than one (1) year. An officer may be removed by the board of directors at any time but removal shall not prejudice any rights that he may have to damages for breach of contract of employment.

Amended by Laws 1988, c. 166, § 6, emerg. eff. May 24, 1988.

§ 712. Liability of directors, officers, and other persons—Overdrafts

A. Liability for violation of bank and trust laws. Any director, officer or other person who shall knowingly participate in any violation of the laws of this state, relative to banks and banking and trust companies, shall be liable for all damages which the corporation, its stockholders, depositors, creditors or owners of trust funds shall sustain in consequence of such violation; and upon proper showing that any director or directors knowingly assented to, participated in, acquiesced in after failure to make due inquiry, or caused a loan to be made in excess of the amounts prescribed in Article VIII of this Code [1] such director or directors shall be individually liable for the amount of such loan and shall be required to eliminate the same from the assets of the bank upon the request of the Commissioner.

B. Liability for overdrafts. Any bank officer or employee who shall knowingly, willfully and fraudulently, for the purpose of defrauding the bank, pay out of the funds of said bank upon the check, order or draft of any individual, firm, corporation or association, which has not on deposit with such bank a sum equal to such check, order or draft, shall be personally liable to such a bank for the amount so paid and such liability shall be covered by his official bond.

C. After August 9, 1989, no claim or action seeking to recover money damages shall be brought by the Federal Deposit Insurance Corporation, Resolution Trust Corporation or other federal banking regulatory agency against any director or officer, including any former director or officer, of any insured financial depository institution as defined in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 [2] unless such claim or action arises out of the gross negligence, or

Attachment #5 — 20
03-16-93

willful or intentional misconduct of such officer or director during his term of office with such insured financial institution.

Amended by Laws 1988, c. 166, § 7, emerg. eff. May 24, 1988; Laws 1992, c. 295, § 28, eff. July 1, 1992.

[1] Section 801 et seq. of this title.

[2] 12 U.S.C.A. § 1811note.

§ 713. Fidelity bonds and other insurance

Notes of Decisions

2. Bonds of officers

Employee fidelity bond that bank maintained pursuant to its obligation under Oklahoma statute was to be reviewed in light of statute, and statute's terms were to be read into bond. Adair State Bank v. American Cas. Co. of Reading, Pa., C.A.10 (Okl.)1991, 949 F.2d 1067.

Bank officer's silence after she had learned of bank chairman's alleged check-kiting scheme was "collusion" with bank chairman, for purposes of determining whether officer's knowledge triggered termination provision under employee fidelity bond; although insurer claimed that officer remained silent in belief that she did not need to speak to anyone other than her superiors, she also tendered month-end report that completely concealed chairman's activities. Adair State Bank v. American Cas. Co. of Reading, Pa., C.A.10 (Okl.)1991, 949 F.2d 1067.

Termination provision of employee fidelity bond was not triggered by bank officers' discovery of bank chairman's check-kiting scheme, even if there was "window" of time between officers' discovery of scheme and decision to hide chairman's dishonest and illegal acts from bank's board. Adair State Bank v. American Cas. Co. of Reading, Pa., C.A.10 (Okl.)1991, 949 F.2d 1067.

§ 715. Applicability of Oklahoma General Corporation Act

The provisions of the Oklahoma General Corporation Act,[1] shall, insofar as the same are not inconsistent herewith, govern corporations operating under the provisions of this Code.

Amended by Laws 1986, c. 292, § 144, eff. Nov. 1, 1986.

[1] Section 1001 et seq. of title 18.

§ 716. Purchase of bank's own stock as treasury stock

With the approval of the Commissioner and subject to such conditions as he may prescribe, a bank may purchase its own stock as treasury stock.

Added by Laws 1991, c. 128, § 4, emerg. eff. April 29, 1991.

ARTICLE VIII. REGULATION OF BANKS

§ 802. Limitations on maximum indebtedness to bank—Exceptions

A. (1) The total obligations to any bank or trust company of any person, copartnership, association or corporation shall at no time exceed twenty percent (20%) of the capital, surplus and undivided profits of the bank or trust company.

(2) Separate from and in addition to this limitation, the total obligation to the bank or trust company of any person, copartnership, association or corporation fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of funds outstanding shall not exceed five percent (5%) of the unimpaired capital, unimpaired surplus and undivided profits of such bank or trust company.

(3) The term "obligations" shall mean the direct liability, exclusive of interest, of the maker or acceptor of paper discounted with or sold to such bank and the liability, exclusive of interest, of the endorser, drawer or guarantor who obtains a loan from or discounts paper with or sells paper under his guaranty to such bank or trust company. It shall also include leases of personal property as provided in Section 419 of this title.

Attachment #5 — 21
03-16-93

Flordia Statutes Annotated

Laws 1970, c. 70–137, § 1.
Laws 1970, c. 70–24, § 3.
Laws 1965, c. 65–103, § 1.
Laws 1953, c. 28170, § 1.
Fla.St.1951, §§ 611.14, 612.29, 612.30.
Comp.Gen.Laws 1927, §§ 6004, 6555, 6556.
Laws 1925, c. 10096, §§ 29, 30.
Rev.Gen.St.1920, § 4075.
Gen.St.1906, § 2663.
Rev.St.1892, § 2138.

Law Review Commentaries

Personal liability of directors in Florida: Whose corporation is it anyway? 15 Nova L.Rev. 1389 (1991).

Playing with fire: Nonshareholder constituency statutes in the 1990s. James J. Hanks, Jr., 21 Stetson L.Rev. (Fla.) 97 (1991).

Notes of Decisions

Construction and application 1
Law governing 2

1. Construction and application

Director or officer of corporation, acting as its agent in purchase of property, occupies position of trust and confidence with respect to corporation and owes corporation fiduciary duty to exercise utmost good faith and to make full disclosure of all facts within his knowledge pertaining to transaction. Tinwood N.V. v. Sun Banks, Inc., App. 5 Dist., 570 So.2d 955 (1990).

Directors of corporation occupy quasi-fiduciary relation to corporation and stockholders. Orlando Orange Groves Co. v. Hale, 107 Fla. 304, 144 So. 674 (1933).

2. Law governing

Corporation's claim that former managing directors arranged for secret profit at expense of and without knowledge of corporation was governed by law of Florida, rather than law of Netherlands Antilles where corporation was incorporated, as director had his office in Florida, corporate purpose of investing in Florida property was to be carried out in Florida, and corporate bank account was maintained in Florida; Florida had most significant relationship to transaction. Tinwood N.V. v. Sun Banks, Inc., App. 5 Dist., 570 So.2d 955 (1990).

607.0831. Liability of directors

(1) A director is not personally liable for monetary damages to the corporation or any other person for any statement, vote, decision, or failure to act, regarding corporate management or policy, by a director, unless:

(a) The director breached or failed to perform his duties as a director; and

(b) The director's breach of, or failure to perform, those duties constitutes:

1. A violation of the criminal law, unless the director had reasonable cause to believe his conduct was lawful or had no reasonable cause to believe his conduct was unlawful. A judgment or other final adjudication against a director in any criminal proceeding for a violation of the criminal law estops that director from contesting the fact that his breach, or failure to perform, constitutes a violation of the criminal law; but does not estop the director from establishing that he had reasonable cause to believe that his conduct was lawful or had no reasonable cause to believe that his conduct was unlawful;

2. A transaction from which the director derived an improper personal benefit, either directly or indirectly;

3. A circumstance under which the liability provisions of s. 607.0834 are applicable;

4. In a proceeding by or in the right of the corporation to procure a judgment in its favor or by or in the right of a shareholder, conscious disregard for the best interest of the corporation, or willful misconduct; or

Attachm 5 — 23
03-16-

5. In a proceeding by or in the right of someone other than the corporation or a shareholder, recklessness or an act or omission which was committed in bad faith or with malicious purpose or in a manner exhibiting wanton and willful disregard of human rights, safety, or property.

(2) For the purposes of this section, the term "recklessness" means the action, or omission to act, in conscious disregard of a risk:

(a) Known, or so obvious that it should have been known, to the director; and

(b) Known to the director, or so obvious that it should have been known, to be so great as to make it highly probable that harm would follow from such action or omission.

(3) A director is deemed not to have derived an improper personal benefit from any transaction if the transaction and the nature of any personal benefit derived by the director are not prohibited by state or federal law or regulation and, without further limitation:

(a) In an action other than a derivative suit regarding a decision by the director to approve, reject, or otherwise affect the outcome of an offer to purchase the stock of, or to effect a merger of, the corporation, the transaction and the nature of any personal benefits derived by a director are disclosed or known to all directors voting on the matter, and the transaction was authorized, approved, or ratified by at least two directors who comprise a majority of the disinterested directors (whether or not such disinterested directors constitute a quorum);

(b) The transaction and the nature of any personal benefits derived by a director are disclosed or known to the shareholders entitled to vote, and the transaction was authorized, approved, or ratified by the affirmative vote or written consent of such shareholders who hold a majority of the shares, the voting of which is not controlled by directors who derived a personal benefit from or otherwise had a personal interest in the transaction; or

(c) The transaction was fair and reasonable to the corporation at the time it was authorized by the board, a committee, or the shareholders, notwithstanding that a director received a personal benefit.

(4) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors which authorizes, approves, or ratifies such a transaction.

(5) The circumstances set forth in subsection (3) are not exclusive and do not preclude the existence of other circumstances under which a director will be deemed not to have derived an improper benefit.

(6) The provisions of this section shall also apply to officers of nonprofit organizations as provided in s. 617.0285.

ıreholder approval; or
· a contract for sale of
ve rights, preferences,
except the board of
:ecutive officer of the
:s) to take the action
:ribed by the board of

ıction by a committee
with the standards of
3; P.L.107-1987, § 11.]

ıd deleted the specific RMA
fying the circumstances un-
ımittee could exercise that

ng was literally correct, and
initially intended by the
reserve prior Indiana law in
ƆA provided, without qualifi-
:ommittee could decide "to
ıpprove any contract to issue
.es or shares of the corpora-
ɘ the terms of a series of a
s or shares." IC 23-1-2-11(g).
:tion, however, the Commis-
ɘd restoring the RMA subdi-
ıor clarifying changes in the
in the 1987 amendments to
.o eliminate the uncertainty
and to impose the RMA's
:s on the circumstances in
tee can perform these impor-
tions.
endments made three other
subsection. First, subdivision
l to permit approval of "other
n addition to share redemp-
vithin a range" prescribed by
nd, this subdivision was also
ıit "an executive officer of the
gnated by the board of direc-
as a committee, to make
l other distribution decisions
board-prescribed formulas,
ıits. These changes permit a
treamline its decision making
as the practical realities of
ate financing may demand.
a modern corporation may
ses of preferred shares for
on and dividend decisions are
:kly basis. Under subdivision
irectors can authorize either a
ın executive officer to make
subject to criteria specified by

Indiana Statutes Annotated.

the board, without having to convene weekly meetings of the full board.

The third 1987 change was in subdivision (4), which generally prohibits a committee from exercising the board's authority, under IC 23-1-38-2, to make certain amendments to the articles of incorporation without shareholder approval. IC 23-1-38-2(7), however, is a catch-all provision authorizing any direct articles amendments by the board expressly permitted by other sections of the BCL; and one such section is IC 23-1-25-2(d), which authorizes a board to amend the articles, without shareholder approval, to reflect the board's determination of the designation and relative rights, preferences and limitations of a class or series of shares. Subdivision (7) here in turn authorizes a committee to exercise, within limits, the board's authority to make such determinations. Accordingly, subdivision (4)'s prohibition on committee amendment of articles of incorporation was qualified by the 1987 amendment adding the words "except to the extent permitted by subdivision (7)," to clarify that a committee authorized to determine the terms of a class or series of shares under subdivision (7) also has authority to make the appropriate amendments to the articles of incorporation under IC 23-1-25-2(d) and IC 23-1-38-2(7).

CHAPTER 35

STANDARDS OF CONDUCT FOR DIRECTORS

23-1-35-1. Enumeration of conduct standards which avert personal liability. — (a) A director shall, based on facts then known to the director, discharge the duties as a director, including the director's duties as a member of a committee:

(1) In good faith;

(2) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) In a manner the director reasonable believes to be in the best interests of the corporation.

(b) In discharging the director's duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) One (1) or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) Legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

(3) A committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

(c) A director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors the director considers pertinent.

(e) A director is not liable for any action taken as a director, or any failure to take any action, unless:

(1) The director has breached or failed to perform the duties of the director's office in compliance with this section; and

(2) The breach or failure to perform constitutes willful misconduct or recklessness.

(f) In enacting this article, the general assembly established corporate governance rules for Indiana corporations, including in this chapter, the standards of conduct applicable to directors of Indiana corporations, and the corporate constituent groups and interests that a director may take into account in exercising the director's business judgment. The general assembly intends to reaffirm certain of these corporate governance rules to ensure that the directors of Indiana corporations, in exercising their business judgment, are not required to approve a proposed corporate action if the directors in good faith determine, after considering and weighing as they deem appropriate the effects of such action on the corporation's constituents, that such action is not in the best interests of the corporation. In making such determination, directors are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor. Without limiting the generality of the foregoing, directors are not required to render inapplicable any of the provisions of IC 23-1-43, to redeem any rights under or to render inapplicable a shareholder rights plan adopted pursuant to IC 23-1-26-5, or to take or decline to take any other action under this article, solely because of the effect such action might have on a proposed acquisition of control of the corporation or the amounts that might be paid to shareholders under such an acquisition. Certain judicial decisions in Delaware and other jurisdictions, which might otherwise be looked to for guidance in interpreting Indiana corporate law, including decisions relating to potential change of control transactions that impose a different or higher degree of scrutiny on actions taken by directors in response to a proposed acquisition of control of the corporation, are inconsistent with the proper application of the business judgment rule under this article. Therefore, the general assembly intends:

(1) To reaffirm that this section allows directors the full discretion to weigh the factors enumerated in subsection (d) as they deem appropriate; and

(2) To protect both directors and the validity of corporate action taken by them in the good faith exercise of their business judgment after reasonable investigation.

(g) In taking or declining to take any action, or in making or declining to make any recommendation to the shareholders of the corporation with respect to any matter, a board of directors may, in its discretion, consider both the short term and long term best interests of the corporation, taking into account, and weighing as the directors deem appropriate, the effects thereof on the corporation's shareholders and the other corporate constituent groups and interests listed or described in subsection (d), as well as any other factors deemed pertinent by the directors under subsection (d). If a determination is made with respect to the foregoing with the approval of a majority of the disinterested directors of the board of the directors, that determination shall conclusively be presumed to be valid unless it can be demonstrated that the determination was not made in good faith after reasonable investigation.

(h) For the purposes of subsection (g), a director is disinterested if:

(1) The director does not have a conflict of interest, within the meaning of section 2 [IC 23-1-35-2] of this chapter, in connection with the action or recommendation in question;

(2) In connection with matters described in IC 23-1-32 the director is disinterested (as defined in IC 23-1-32-4(d));

(3) In connection with any matter involving or otherwise affecting:

(A) A control share acquisition (as defined in IC 23-1-42-2) or any matter related to a control share acquisition under IC 23-1-42 or other provisions of this article;

(B) A business combination (as defined in IC 23-1-43-5) or any matter related to a business combination under IC 23-1-43 (including a person becoming an interested shareholder) or other provisions of this article; or

(C) Any transaction that may result in a change of control (as defined in IC 23-1-22-4) of the corporation;

the director is not an employee of the corporation; and

(4) In connection with any matter involving or otherwise affecting:

(A) A control share acquisition (as defined in IC 23-1-42-2) or any matter related to a control share acquisition under IC 23-1-42 or other provisions of this article;

(B) A business combination (as defined in IC 23-1-43-5) or any matter related to a business combination under IC 23-1-43 (including a person becoming an interested shareholder) or other provisions of this article; or

(C) Any transaction that may result in a change of control (as defined in IC 23-1-22-4) of the corporation;

the director is not an affiliate or associate of, or was not nominated or designated as a director by, a person proposing any of the transactions described in clause (A), (B), or (C).

(i) A person may be disinterested under this section even though the person is a director or shareholder of the corporation. [P.L.149-1986, § 19; P.L.227-1989, § 2.]

Notre Dame Law Review. Target Directors' Fiduciary Duties: An Initial Reasonableness Burden, 61 Notre Dame L. Rev. 722 (1986).

Maine Revised Statutes

Intervention

Superior Court abused its discretion by gran g motion to intervene as shareholder for corpo tion on third day of legal malpractice trial, here shareholder had unjustifiably delayed, as areholder could have moved to intervene or nend pleadings at any time during nine years ice filing of suit, action left attorney with no portunity to prepare defense against deriva e claim, and witnesses who had testified prior third day of trial were not available for cross mination with regard to claim presented by poration. Spickler v. York (1989) Me., 566 d 1385.

7

OFFICERS

text of 1, A]

ext of 2 to 4]

ory Notes

er of directors in a close corporation ged by the shareholders.

ns

ction of new directors

ision in target corporation's articles and mandating that vacancies in board of rs resulting from removal from office be y majority vote of directors then in office Maine Business Corporations Act sec at permitted filling vacancies at same at which vacancy was created. Geor fic Corp. v. Great Northern Nekoosa).Me.1990, 731 F.Supp. 38.

ration's articles of incorporation and by at attempted to impose 90-day notice nent for nomination of director candi ter removal of directors at shareholder violated Maine Business Corporations ion permitting election of new directors meeting at which directors had been without prior notice of election. Geor ic Corp. v. Great Northern Nekoosa Me.1990, 731 F.Supp. 38.

rs

t of 1]

ectors or of any committee is held taken at such meeting is deemed

ratified by a director or committee member who did not attend unless, after learning of the action taken and of the impropriety of the meeting, the director or committee member makes prompt objection to the action taken.

[See main volume for text of 3 to 5]

R.R. 1991, c. 2, § 42.

Historical and Statutory Notes

Codification

Revisor's Report 1991, c. 2, § 42, in subsec. 2, corrected spelling of "committee" following "deemed ratified by a director or", made provisions gender-neutral, and made grammar and punctuation changes.

Notes of Decisions

1. Objection

Corporate director waived right to object to inadequacy of notice of special meeting of board of directors, as there was no evidence that director objected to the inadequacy of notice when she received the notice or when she attended special board meeting and director made no written objection until months after the meeting. Webber v. Webber Oil Co. (1985) Me., 495 A.2d 1215.

§ 715. Vacancies in office; removal of officers

Notes of Decisions

1. Removal

Superior court had no jurisdiction to remove corporate president from office. Webber v. Webber Oil Co. (1985) Me., 495 A.2d 1215.

§ 716. Duty of directors and officers

The directors and officers of a corporation shall exercise their powers and discharge their duties in good faith with a view to the interests of the corporation and of the shareholders and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions. In discharging their duties, directors and officers may in all cases rely upon financial statements of the corporation to the extent provided in section 720, subsection 4.

In discharging their duties, the directors and officers may, in considering the best interests of the corporation and of its shareholders, consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments of the corporation are located and all other pertinent factors.

A director shall not be held personally liable for monetary damages for failure to discharge any duty as a director unless the director is found not to have acted honestly or in the reasonable belief that the action was in or not opposed to the best interests of the corporation or its shareholders.

1985, c. 394, § 2; 1987, c. 663, § 1.

Historical and Statutory Notes

1985 Amendment. Chapter 394 added 2nd paragraph.

1987 Legislation

Laws 1987, c. 663, added the last paragraph.

Notes of Decisions

2. Fiduciary relationship

Corporate directors' fiduciary duties included furthering interest of each other, rather than merely furthering interest of business enterprise, given special nature of family business, which most closely resembled the single complex family partnership doing business through numerous entities of varied legal forms. Rosenthal v. Rosenthal (1988) Me., 543 A.2d 348.

Attachment #5 — 28
03-16-93

IMENT

:d by new divisions
anion amendments
ome Ohio corpora-
/oting, the amend-
re needed to distin-
to voting methods.
me as former divi-
ımulative voting is
from removal from
cumulative voting
his removal.
rporations without
of directors by ma-
contrary provisions

portion of former
acancies caused by
ntroductory clause
'ision (E) applies to
rporations, regard-

sion (D), but it has
ommodate the fore-

. 1701.04, 1701.55,

IMENT

hat a director may
time at which it is
of the resignation is

ıat all of the direc-
;, or an individual
olders who are enti-
ent section is defec-
le by the sharehold-
ass of shares which
may be cases where
ıss, acting pursuant
ares, elect a class of
:d shares may have
es that elected these
to provide that the
ılders who have the
s. This division also
t the articles or the
of directors or may
than is specified in

clear that the veto
emoval is the same
ne or more directors
the directors are to
ified, or if less than
are to be removed,
umulative voting on
ctors or on the basis
ticular class, as the

tion, RC § 2733.20

ition, RC § 1702.29.

Ohio Revised Code

Text Discussion

Removal of directors; filling vacancies. 1 Seaver p. 118

Forms

Eliminating cumulative voting. 1 Couse No. 1.10; 1 Seaver No. 1.10

Resignation of director or officer. 1 Couse No. 1.76; 1 Seaver No. 1.76

Research Aids

Removal of directors:
- O-Jur3d: Bus Rel § 341
- Am-Jur2d: Corp §§ 1427, 1428, 1433, 1444
- C.J.S.: Corp § 454

Resignation of directors:
- O-Jur3d: Bus Rel § 343
- Am-Jur2d: Corp § 1419
- C.J.S.: Corp § 452

Vacancies in board:
- O-Jur3d: Bus Rel §§ 331, 332
- Am-Jur2d: Corp § 1400
- C.J.S.: Corp § 466

West Key No. Reference
- Corp 292–294

ALR

Power of directors of private corporation to remove officers or fellow directors. 63 ALR 776.

Provision authorizing directors to fill vacancies as applicable to newly created directorships. 6 ALR2d 174.

Removal by court of director or officer of private corporation. 124 ALR 364.

Resignation: when resignation of officer of private corporation becomes effective. 20 ALR 267.

Validity of agreement in conjunction with sale of corporate shares that majority of directors will be replaced by purchaser's designees. 13 ALR3d 361.

Law Review

Cumulative voting, yesterday and today: The July, 1986 amendments to Ohio's general corporation law. June A. Striegel. 55 CinLRev 1265 (1987).

Qualifications of securities in California: hostile territory for foreign issuers. James K. Roosa. 23 AkronLRev 241 (1989).

State and federal regulation of shark repellent provisions: How much is needed? Roger E. Lautzenhiser. 11 NoKyLRev 481 (1984).

§ 1701.59 Authority of directors; bylaws; standard of care.

(A) Except where the law, the articles, or the regulations require action to be authorized or taken by shareholders, all of the authority of a corporation shall be exercised by or under the direction of its directors. For their own government, the directors may adopt bylaws that are not inconsistent with the articles or the regulations. The selection of a time frame for the achievement of corporate goals shall be the responsibility of the directors.

(B) A director shall perform his duties as a director, including his duties as a member of any committee of the directors upon which he may serve, in good faith, in a manner he reasonably believes to be in or not opposed to the best interests of the corporation, and with the care that an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, that are prepared or presented by:

(1) One or more directors, officers, or employees of the corporation who the director reasonably believes are reliable and competent in the matters prepared or presented;

(2) Counsel, public accountants, or other persons as to matters that the director reasonably believes are within the person's professional or expert competence;

(3) A committee of the directors upon which he does not serve, duly established in accordance with a provision of the articles or the regulations, as to matters within its designated authority, which committee the director reasonably believes to merit confidence.

(C) For purposes of division (B) of this section:

(1) A director shall not be found to have violated his duties under division (B) of this section unless it is proved by clear and convincing evidence that the director has not acted in good faith, in a manner he reasonably believes to be in or not opposed to the best interests of the corporation, or with the care that an ordinarily prudent person in a like position would use under similar circumstances, in any action brought against a director, including actions involving or affecting any of the following:

(a) A change or potential change in control of the corporation, including a determination to resist a change or potential change in control made pursuant to division (F)(7) of section 1701.13 of the Revised Code;

(b) A termination or potential termination of his service to the corporation as a director;

(c) His service in any other position or relationship with the corporation.

(2) A director shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause reliance on information, opinions, reports, or statements that are prepared or presented by the persons described in divisions (B)(1) to (3) of this section to be unwarranted.

(3) Nothing contained in this division limits relief available under section 1701.60 of the Revised Code.

(D) A director shall be liable in damages for any action he takes or fails to take as a director only if it is proved by clear and convincing evidence in a court of competent jurisdiction that his action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation. Nothing contained in this division affects the liability of directors under section 1701.95 of the Revised Code or limits relief available under section 1701.60 of the Revised Code. This division does not apply if, and only to the extent that, at the time of a director's act or omission that is the subject of complaint, the articles or the regulations of the corporation state by specific reference to this division that the provisions of this division do not apply to the corporation.

(E) For purposes of this section, a director, in determining what he reasonably believes to be in the best interests of the corporation, shall consider the interests of the corporation's shareholders and, in his discretion, may consider any of the following:

(1) The interests of the corporation's employees, suppliers, creditors, and customers;

(2) The economy of the state and nation;

(3) Community and societal considerations;

(4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

(F) Nothing contained in division (C) or (D) of this section affects the duties of either of the following:

(1) A director who acts in any capacity other than his capacity as a director;

(2) A director of a corporation that does not have issued and outstanding shares that are listed on a national securities exchange or are regularly quoted in an over-the-counter market by one or more members of a national or affiliated securities association, who votes for or assents to any action taken by the directors of the corporation that, in connection with a change in control of the corporation, directly results in the holder or holders of a majority of the outstanding shares of the corporation receiving a greater consideration for their shares than other shareholders.

HISTORY: 126 v 432(467) (Eff 10-11-55); 130 v S 264 (Eff 10-14-63); 132 v S 75 (Eff 10-31-67); 138 v S 174 (Eff 8-7-80); 139 v H 455 (Eff 11-17-81); 140 v H 262 (Eff 10-10-84); 140 v H 607 (Eff 4-1-85); 141 v H 902 (Eff 11-22-86); 141 v H 428 (Eff 12-23-86); 142 v H 708 (Eff 4-19-88); 143 v S 321. Eff 4-11-90.

Not analogous to former RC § 1701.59. The first sentence is based substantially on former RC § 1701.63 (GC § 8623-55; 112 v 9; 113 v 413; 123 v 275; Bureau of Code Revision, 10-1-53); the second sentence is based on former RC § 1701.70 (GC § 8623-61; 112 v 9(34), § 61; Bureau of Code Revision, 10-1-53).

Editor's Note:

In most states the term "bylaws" is used to refer to rules passed by the shareholders. In Ohio such rules are called "code of regulations," RC § 1701.11.

1986 COMMITTEE COMMENT

The addition to division (B) conforms it to division (E) of Sec. 1701.13, which, among other things, provides for director indemnification.

The changes in division (C) are intended to make it clear that a director has the benefit of a presumption that he is acting in good faith and in a manner he reasonably believes is in (or not opposed to) the best interests of the corporation in all cases, including those affecting or involving a change in control or a termination of his services. It is believed that the changes are necessary because of the adoption by some courts, notably those of Delaware, of the view that, in such cases, the director becomes an interested party and, as a result, loses the benefit of the business judgment rule.

Division (D) is new. It is designed to relieve the director of responsibility for money damages except when it is proven by clear and convincing evidence that the director has breached or failed to perform his duties and that his act or omission in so doing was consciously undertaken with deliberate intent to cause injury to the corporation or with reckless disregard for the interests of the corporation. The amendment frees the director from monetary liability for negligence in any degree. The amendment does not affect other forms of relief and the directors remain liable for violations of Sec. 1701.95.

It is believed to be important for corporations to be able to obtain and retain those persons who can best serve as directors. It is also important that the directors of corporations feel free to use their best judgment in making business decisions that are in the best interest of the corporation and its shareholders without undue concern for personal liability. It is also believed that it is important for corporations to be able to attract and retain "outside" (non-management) directors who are in a position to provide independent judgment. The amendments to Sec. 1701.59 are designed to help achieve these goals.

1984 COMMITTEE REPORT

The purpose of the amendment adding division (D) is to make clear that, in determining what is in the best interest of the corporation, a director, in addition to considering the interests of the corporation's shareholders, may take into account the interest of others specified in the amendment on whom directors' decisions may have an effect.

The Committee believes that Ohio law presently permits a director to take into account interests other than those of shareholders; however, the Committee believes that it is desirable to specify and clarify the breadth of the interests which a director may consider.

See the first paragraph of the 1984 comment following Sec. 1701.59.1.

1967 COMMITTEE COMMENT

The purpose of the amendment adding division (B) is to establish a good faith reliance test for determining the responsibility of directors in the discharge of their duties. Reference is made to Sec. 1701.37(A) for a statement of the obligation of a corporation to maintain books and records of account and to Sec. 1701.95 for a statement of the director's right to rely upon financial statements of the corporation in the defense of liabilities which may be inserted under divisions (A)(1) or (2) thereof.

See the comment following Sec. 1701.11 respecting the deletion of the former last sentence of division (A).

1955 COMMITTEE COMMENT

The first sentence is taken from present Sec. 1701.63, except that the provisions in the present section as to the number of directors and their qualifications are left out, as being more appropriately covered in other sections. The second sentence is taken from present Sec. 1701.70.

:71 N.W. River Imp. Co. v. Holway (1893) 55 N.W. 418, 85 Wis. 344.

ovement gs to be ent that nmittee, . Black Corporation could not amend articles in order to give directors the authority to delegate their powers to a special committee, officer or agent. 1908 Op.Atty.Gen. 208.

:tors or officers

·r has knowledge that makes reliance unwar-
ı discharging his or her duties to the corpora-
ı, opinions, reports or statements, valuation
.vritten or oral, formal or informal, including
reports and other financial data, if prepared or
ing:

the corporation whom the director or officer
iable and competent in the matters presented.

:ountants or other persons as to matters that
in good faith are within the person's profes-

by a director, a committee of the board of
- is not a member if the director believes in
:nerits confidence.

:al and Statutory Notes

Prior Laws:
1987 Act 13, § 8, eff. June 13, 1987.
St. 1987, § 180.303.

:ross References

section, see § 611.62.

:brary References

Wisconsin Practice, Methods of Practice, Rev.Ed., Vol. 2A (1987), Sherman, § 43.22.

interests in addition to shareholders' inter-

es to the corporation and in determining what
›est interests of the corporation, a director or
idering the effects of any action on sharehold-

on employes, suppliers and customers of the

ı on communities in which the corporation

: director or officer considers pertinent.

Wisconsin Statutes Annotated

Historical and Statutory Notes

Source:
1989 Act 303, § 13, eff. Jan. 1, 1991.

Prior Laws:
1987 Act 13, § 8, eff. June 13, 1987.
St.1987, § 180.305.

Cross References

Insurance corporations, application of section, see § 611.62.

Library References

Corporations ⇐310(1).
WESTLAW Topic No. 101.
C.J.S. Corporations §§ 475 to 489.

180.0828. Limited liability of directors

(1) Except as provided in sub. (2), a director is not liable to the corporatio: its shareholders, or any person asserting rights on behalf of the corporatic or its shareholders, for damages, settlements, fees, fines, penalties or othe monetary liabilities arising from a breach of, or failure to perform, any du resulting solely from his or her status as a director, unless the persc asserting liability proves that the breach or failure to perform constitutes ar of the following:

(a) A wilful failure to deal fairly with the corporation or its shareholders i connection with a matter in which the director has a material conflict ‹ interest.

(b) A violation of criminal law, unless the director had reasonable cause t believe that his or her conduct was lawful or no reasonable cause to belie\ that his or her conduct was unlawful.

(c) A transaction from which the director derived an improper person: profit.

(d) Wilful misconduct.

(2) A corporation may limit the immunity provided under this section b its articles of incorporation. A limitation under this subsection applies if th cause of action against a director accrues while the limitation is in effec

Historical and Statutory Notes

Source:
1989 Act 303, § 13, eff. Jan. 1, 1991.

Prior Laws:
1987 Act 13, § 8, eff. June 13, 1987.
St.1987, § 180.307.

Cross References

Insurance corporations, application of section, see § 611.62.

Library References

Corporations ⇐310(1).
WESTLAW Topic No. 101.
C.J.S. Corporations §§ 475 to 489.

WESTLAW Electronic Research

See WESTLAW Electronic Research Guide following the Preface.

Attachment #5 — 31
03-16-93

MAR-12-'93 FRI 15

FILE
73 93

TEXAS LEGISLATIVE COUNCIL
Preliminary Draft

By C. Harris

S.B. No. 319

A BILL TO BE ENTITLED

AN ACT

relating to the personal liability of officers and directors of insured depository institutions.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

SECTION 1. Article 10, Chapter IV, The Texas Banking Code (Article 342-410, Vernon's Texas Civil Statutes), is amended to read as follows:

Art. 10. DIRECTORS, OFFICERS AND EMPLOYEES--LIABILITY--REIMBURSEMENT FOR EXPENSES. A. Except as otherwise provided by statute, directors and officers of state banks shall be liable for financial losses sustained by state banks to the extent that directors and officers of other corporations are now responsible for such losses in equity and common law. Any officer or director who does not approve of any act or omission of the board, and desires to relieve himself from any personal liability for such act or omission shall promptly announce his opposition to such act or omission and cause such opposition to be spread upon the minutes of the directors' meeting. If for any reason such opposition is not spread upon the minutes of the directors' meeting, he shall promptly report the facts to the Banking Commissioner.

B. Any person may be indemnified or reimbursed by a state bank, through action of its board, for reasonable expenses actually incurred by him in connection with any action, suit or proceeding

Attachment #5 — 33
03-16-93

to which he is a party by reason of his being or having been a director, officer or employee of said bank or having served as a director, officer, partner, venturer, proprietor, trustee, agent, or similar functionary of another foreign or domestic corporation, partnership, joint venture, sole proprietorship, trust, employee benefit plan, or other enterprise, at the request of the bank. The board may authorize the purchase by the bank of insurance covering the indemnification of directors, officers or employees and may prospectively indemnify directors, officers, or employees. If there is a compromise of such an action or threatened action, there shall be no indemnification or reimbursement for the amount paid to settle the claim or for reasonable expenses incurred in connection with such claim without the vote, or the written consent, of the owners of record of a majority of the stock of the bank. No such person shall be indemnified or reimbursed if he has been finally adjudged to have been guilty of, or liable for, willful misconduct, gross neglect of duty, or a criminal act. This article shall not bar any right or action to which such person would be entitled at common law or any other statute of this State.

C. For the purpose of applying this article to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Pub. L. No. 101-73, 12 U.S.C. Section 1811 et seq.), a disinterested director or officer of an insured depository institution may not be held personally liable in an action seeking monetary damages brought by the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, or any other federal banking regulatory agency as provided by 12 U.S.C. Section 1821(k) unless the damages arise from the gross negligence or wilful or intentional misconduct of the officer or director during the officer's or director's term of office with the insured depository institution. A director or officer is disinterested with respect to a decision or transaction if the decision or transaction does not involve:

(1) personal profit for the director or officer by dealing with the insured depository institution or usurping an opportunity of the institution;

(2) buying or selling assets of the insured depository institution;

(3) dealing with another insured depository institution or a corporation or other entity in which the director or officer:

(A) is also a director or officer; or

(B) has a significant financial interest; or

(4) dealing with a family member of the director or officer.

D. In this article, "insured depository institution" has the meaning assigned by 12 U.S.C. Section 1813(c).

SECTION 2. This Act is not intended to change existing law regarding the personal liability of a director or officer of an insured depository institution but is a clarification of the law in effect immediately before the effective date of this Act regarding those matters. This Act applies to an action brought by a federal regulatory agency under 12 U.S.C. Section 1821(k) against a director or officer of an insured depository institution, regardless of whether the action was filed before, on, or after the effective date of this Act, unless the action was finally adjudicated by a court of competent jurisdiction before the effective date of this Act.

SECTION 3. The importance of this legislation and the crowded condition of the calendars in both houses create an emergency and an imperative public necessity that the constitutional rule requiring bills to be read on three several days in each house be suspended, and this rule is hereby suspended, and that this Act take effect and be in force from and after its passage, and it is so enacted.

LEGISLATURE OF NEBRASKA

NINETY-THIRD LEGISLATURE

FIRST SESSION

Legislative Bill 253

Introduced by Kristensen, 37; Fisher, 35

Read first time January 11, 1993

Committee: Judiciary

A BILL

FOR AN ACT relating to banking and finance; to provide for director and officer liability as prescribed.

Be it enacted by the people of the State of Nebraska,

printed with soy ink on recycled paper

AM0288
LB 253
NN-02-09

AM0288
LB 253
NN-02-09

AMENDMENTS TO LB 253

1. Insert the following new sections:

"Sec. 2. On or after the effective date of this act, no claim or action seeking to recover money damages shall be brought by the Federal Deposit Insurance Corporation, Resolution Trust Corporation, or other federal banking regulatory agency against any director or officer, including any former director or officer, of any insured financial depository institution as defined in the Financial Institutions Reform, Recovery and Enforcement Act of 1989, unless such claim or action arises out of the gross negligence or willful or intentional misconduct of such officer or director during his or her term of office with such insured financial depository institution.

Sec. 3. If any section in this act or any part of any section shall be declared invalid or unconstitutional, such declaration shall not affect the validity or constitutionality of the remaining portions thereof.".

2. On page 2, line 1; after the second comma insert "until the effective date of this act,".

KANSAS BAR ASSOCIATION

Legislative Information for the Kansas Legislature

TO: **House Judiciary Committee**

FROM: **Ron Smith, KBA General Counsel**

SUBJ: **SB 355, as amended; Senate Floor Action**

SUMMARY:

The Board of Governors of the KBA supports the committee amendments to SB 355.

BACKGROUND:

This legislation is an outgrowth of trends in RTC or FDIC litigation in the wake of the savings and loan crisis. Because some of the S&L or bank directors and officers are culpable in terms of reimbursing the regulators for monies paid to depositors, the FDIC also has aggressively been pursuing all other professionals who have anything to do with the failed institution.

This includes lawyers and CPAs.

It is one thing to hold attorneys and CPAs liable for demonstrated malpractice. It is another to hold them to a standard of care in representing the institution they had no way of knowing *at the time they were hired* would be required of them.

This bill is narrowly focused.

It speaks only to the narrow range of litigation where the FDIC or RTC has taken over the operation of a financial institution and sues to recover funds for alleged mismanagement of the institution.

SB 355 does NOT affect the liability of lawyers or CPAs *who are bank employees.* Their liability is covered in SB 125.

Sometimes the retained CPAs and lawyers and their firms who represented the bank for accounting or legal services are alleged to be culpable on a variety of negligence theories. Sometimes the allegation is made that because of their education, these lawyers and CPAs should be advising the bank officers and directors as to whether certain loans are prudent.

"Prudence" is for bankers to determine. Lawyers advise the bank whether loans are legal or illegal based on the law. CPAs advise the bank on matters affect-

This legislative analysis is provided in a format easily inserted into bill books. We hope you find this convenient.

HOUSE JUDICIARY
Attachment #6
03-16-93

ing the accounting aspects of the bank.

Whether a banker should make an otherwise legal loan is a matter of judgment. Lawyers and CPAs *who are not retained to specifically help make those judgment decisions* should not be held to this higher standard.

If FDIC and RTC want to require banks, when hiring lawyers and CPAs, to hire them to make such decisions *in addition to* legal and accounting services, that can be accomplished through FDIC regulations. The first clause of SB 355, "Unless otherwise agreed in writing," allows bankers to make additional requirements known in writing.

If the lawyer or CPA voluntarily takes on these additional duties in writing, he or she is liable if there is later culpability.

1. SB 355 does not create a higher standard of liability for CPAs or Lawyers. If CPAs or Lawyers malpractice, they can be sued by RTC or FDIC for that negligence. Such negligence is well recognized in our state case law.

2. SB 355 does not prevent FDIC or RTC from creating higher standards of care in providing legal or accounting services to banks. It must be done in writing, however.

3. Finally, SB 355 does not preclude FDIC lawsuits against CPAs and Lawyers.

What this bill does is simply attempt to keep the RTC and FDIC from raising a higher standard of care towards which lawyers and CPAs are supposed to meet when these professionals do not know *at the time they undertake the representation* what that higher standard will be.

The question has arisen as to retroactivity. The Society of CPAs will offer an amendment effecting retroactivity, which is supported by the Bar.

CONCLUSION

I shall be available if you have further questions. The Board of Governors asks for your support on SB 355. Thank you.

III. CIVIL AND CRIMINAL LIABILITY OF LAWYERS REPRESENTING INSURED DEPOSITORY INSTITUTIONS: ISSUES RAISED BY LIABILITY SUITS AGAINST LAWYERS BY THE FEDERAL BANKING AGENCIES[314]

A. Introduction

The FDIC and RTC (and the RTC's predecessor agency, the FSLIC), in their capacity as receivers for failed financial institutions, have traditionally tended to file suits against lawyers only on the basis of traditional malpractice claims. These claims included the widely accepted theories of negligence, breach of fiduciary duty, and breach of contract. These theories all had the common elements of (1) the existence of a duty; (2) a breach of that duty; (3) proximate cause; and (4) damages.[315]

Recent civil actions by the FDIC and RTC seem to indicate that the federal banking agencies have developed new and controversial theories of attorney liability which reach well beyond traditional malpractice claims.[316] Because most FDIC and RTC professional liability suits settle prior to trial there has been very little thoughtful judicial analysis on the validity of these novel theories. This Part seeks to familiarize the reader with some of the theories of attorney liability that have arisen in recent federal banking agency liability suits against lawyers. This Part will also spell out briefly the range of federal criminal law provisions and prosecution theories which relate to

---

[314] The initial draft for this Part was prepared by Carol Elder Bruce, member of the Working Group and an attorney at the firm of Covington & Burling.

[315] J. Villa, Bank Directors,' Officers,' and Lawyers' Civil Liability 2-16 (1992); 1 R. Mallen & J. Smith, Legal Malpractice § 8.1, at 400 and 401 (3d ed. 1989).

[316] For a listing of RTC malpractice suits against lawyers, see *Summary List of Legal Malpractice Actions*, 1(37) Bank Lawyer Liability 15 (Jan. 8, 1993). For recent reportage on the litigation strategies of both the FDIC and RTC, see Vic Simon, *RTC Walks Tightrope in Liability Suits*, American Banker, Jan. 8, 1993, at 4.

A specialist publication devoted exclusively to FDIC and RTC litigation is *Bank Bailout Litigation News* (now in its third annual volume).

Attachment #6 — 3
03-16-93

counsel's obligations towards the financial institutions they represent.

Some of the new theories of liability implicate various ethical rules that govern lawyers' conduct. These rules may be referenced briefly here but will be discussed more fully in the Part IV.

B. Expanded Civil Liability

FDIC and RTC law suits in federal district courts against former outside counsel to failed financial institutions are usually brought by these agencies in their capacities as receivers for and successors-in-interest to the now-defunct financial institutions.[317] As receivers, the agencies succeed to all the "rights" and "assets" of the failed banks and thrifts, including any causes of action for malpractice or other claim the financial institution may have against its former counsel. The regulators interpret their successory rights to imply that, as receivers, they also inherit any attorney-client privilege held by the failed institutions. Discovery in ensuing law suits is potentially made easier for the federal agency-receivers because they may (and in practice do) waive the former institution's attorney-client privilege. Moreover, a receiver will gain access to the attorney's own files (i.e., her "work product") either by requesting, as the successor-in-interest to the attorney-client relationship, the production of all the files relating to any transactions which are under scrutiny or by issuing an administrative subpoena or filing a replevin action for the attorney work product. The FDIC generally proceeds by request; the RTC, by administrative subpoena.[318]

Law suits against outside counsel regularly include the outside counsel's law firm as a named party. Under general agency principles,

---

[317] As receivers, the FDIC and RTC succeed to all "rights, titles, powers, and privileges of the insured depository institution, and of any stockholder, member, account holder, depositor, officer, or director of such institution with respect to the institution and the assets of the institution." 12 USC §§ 1821(d)(2)(A)(1) (FDIC), 1441a(b)(4)(A) (RTC). Recently, the FDIC and RTC, as receivers, have assigned the financial institutions' claims against professionals to the FDIC or RTC in their corporate capacities in so-called "purchase and assumption" transactions.

[318] If the subpoenaed firm fails to produce the work product, then the agency may file a civil action in a U.S. District Court, typically in the District of Columbia, to enforce the subpoena. 12 USC § 1818(n).

liability of an attorney may be imputed to her law firm. Generally, partners are liable for the tortious acts of other partners if the acts were committed in the ordinary course of business of the partnership or if the partners authorized those acts.

The most common claims are made against attorneys who have played the dual role of outside counsel to a financial institution while serving on its board of directors, i.e., the attorney-directors. The banking agencies hold these attorney-directors to higher standards than other directors and scrutinize obvious conflict of interest issues. Outside counsel who have been involved in multiple representations (e.g., simultaneously representing the financial institution and its holding company) are also typically targeted for civil liability. Outside counsel who have not served as directors but who have provided legal services to institutions have also been the subject of banking agency lawsuits when their acts or omissions allegedly constitute malpractice and their conduct was assertedly the proximate cause of the institution's financial losses.

In addition to stepping up administrative enforcement activity, the federal banking agencies have increased the number of civil law suits filed against attorneys. Many of these suits contain paragraphs articulating theories of misconduct which may go beyond accepted principles of professional liability, including expansive malpractice and related theories in the areas of negligence, fraud, breach of contract, unjust enrichment, misrepresentation, aiding and abetting, and breach of fiduciary duty.

In the view of many lawyers, the new liability theories strain or ignore established principles and parameters of the attorney-client relationship in favor of broad principles which, as one commentator put it, "would seem to require lawyers to view their primary role as policemen of their clients, with overriding obligations to the attainment of federal regulatory policy as construed by the OTS."[319] Under some of the theories, counsel would appear to have responsibilities not only to their institutional client but also unprecedented responsibilities

---

[319] Sidney S. Rosdeitcher, *The Thrift Crisis and Lawyers' Liability, Civil and Criminal Liability of Officers, Directors, and Professionals* in PRACTICING LAW INSTITUTE, BANK & THRIFT LITIGATION IN THE 1990's 243 (No. 595, September 1991).

to the government regulators and the public at large.[320]

The new liability theories are sometimes advanced by the agencies under the rubric of "federal common law" as a means of overcoming established state law and precedents allowing imputation to a bank (and, by extension, to the federal regulatory agency as its successor-in-interest) the wrongdoing of bank officers, directors, and shareholders. By avoiding such imputation, the federal receivers are able to foreclose the availability of traditional malpractice defenses such as fraud and contributory negligence.

We will first discuss the federal common law and imputation issue below and then briefly summarize the federal agencies malpractice theories.

1. The Imputation Debate: The Assertion of Federal Common Law By Federal Banking Agencies

Perhaps the most significant development in the area of malpractice litigation brought by the FDIC and RTC against attorneys is the position recently taken by the FDIC in several different cases on the question of which rule of decision - state law or federal common law - applies in such litigation. The federal courts are permitted to develop federal common law only in certain limited situations.[321] The

---

[320] See, for example, the discussion concerning the scope of an attorney's fiduciary duties, in Part II(B)(1)(d) above, and Part IV(C)(4)(d) below.

[321] The Supreme Court has articulated a two-part test for determining whether a court should fashion a federal common law to apply in place of otherwise-applicable state law: first, the court should determine whether Congress intended federal law to govern the dispute; and, second, the court should decide whether it is necessary to fashion a uniform federal rule or merely incorporate relevant state law. The latter determination involves a balancing of three factors that address the relative needs of the federal agency seeking application of a federal common law and the state-law-based expectations of other parties. See *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 727-729 (1979). The Court has indicated that "[t]he presumption that state law should be incorporated into federal common law is particularly strong in areas in which private parties have entered legal relationships with the expectation that their rights and obligations would be governed by state-law standards." (*Kamen v. Kemper Financial Services, Inc.*, 111 S.Ct. 1711, 1717 (1991) (citing *Kimbell Foods*, 440 U.S. at 728-29).

Attachment #6 — 6
03-16-93

FDIC as receiver[322] has, however, argued in several circuits that the courts should reject state law and, instead, create federal common law because such a rule of decision "best serves the Congressional goal of maximum recovery for the FDIC."[323]

The goal of the regulators' federal preemption position is to avoid the consequences of particular state law on the issue of imputation. Under state law in many jurisdictions, the wrongdoing of a party with 100% shareholding in a financial institution (or employees of the institution acting within the scope of their authority) is attributable to the insolvent corporation and, ultimately, imputed to the federal receiver which acquires and stands in the shoes of the bank.[324] Once the wrongdoing is so imputed, the defendant attorney can avail him or herself of the traditional equitable defenses available against a dishonest or fraudulent client - such as fraud or contributory negligence. If the government is able to avoid imputation by persuading a court to create federal common law and reject state law, then these equitable defenses ordinarily available against a bank in malpractice proceedings would not be available against the federal receiver.

---

[322] As indicated above, the federal banking agencies have acted in their capacities as receivers in bringing law suits against attorneys and law firms. But the argument also may be made that even if the FDIC, in its corporate capacity, were to bring an action against a law firm state law should still be the rule of decision. For example, when FDIC/corporate acquires assets in the form of causes of actions from FDIC/receiver it brings these actions in its corporate capacity and the causes of action are "deemed to arise under the laws of the United States." 12 USC § 1819. "Generally, this statutory provision is viewed both as a jurisdictional grant and as a charge to the federal courts to develop federal common law consistent with the policy goals of the [Federal Deposit Insurance Corporation] Act ... . The charge to develop federal common law does not compel a court to reject the incorporation of state law as a means of giving content to that federal law, however." *FDIC v. Clark*, No. 88-F-647, (D. Colo. filed March 23, 1989), *aff'd*, 978 F.2d 1541 (10th Cir. 1992). slip op. at 5 (citations omitted).

[323] See, *id.* U.S.D.Ct. slip op. at 11 n. 1.

[324] One case, *FDIC v. Ernst & Young*, 967 F. 2d 166 (5th Cir. 1992), held that bank officers' fraud would be imputed to FDIC because, as receiver, the agency stood in the shoes of the failed bank. The *Ernst & Young* panel left open the question of whether the FDIC suing in its corporate capacity as insurer could avoid imputation.

Attachment #6 - 7
03-16-93

The FDIC argues that the courts should not apply state imputation law to the FDIC because the FDIC "has a special status" and acts "for the benefit of the 'universe of corporate interests' including the thrift's creditors and depositors."[325] One court has observed, however, that

> courts have expressed reservation at the prospect of applying federal law to preexisting tort claims, effectively changing the nature of a tort simply because assignment permits prosecution by a plaintiff with a Congressional interest in maximum recovery.[326]

Yet in *Federal Deposit Insurance Corp. v. O'Melveny & Meyers*[327] a panel of the Ninth Circuit, without the benefit of briefing on the issue and without citing any precedent, "established" federal common law by ruling that "equitable defenses good against a bank do not carry over against the bank's receiver."[328] The *O'Melveny* opinion may be inconsistent with the Fifth Circuit's decision in *FDIC v. Ernst & Young*,[329] with the decision of the Tenth Circuit in *FDIC v. Ferguson*,[330] and with the Ninth Circuit's own decision in a related

---

[325] Brief of Appellant FDIC in its Response to Petition for Rehearing and Suggestion for Rehearing en Banc, *FDIC v. O'Melveny & Myers*, page 4.

[326] *Clark*, supra note 322, U.S.D.Ct. slip op. at 10.

[327] 969 F.2d 744 (9th Cir. 1992). (The second part of the firm's title ("Myers") is misspelt in the report of the case.)

[328] *Id.* at 751. The court did not cite the Supreme Court decisions, such as *Kamen* and *Kimbell Foods*, supra note 321, governing the development of federal common law.

[329] 967 F.2d 166 (1992). See also, *FDIC v. Mmahat*, 907 F.2d 546 (5th Cir. 1990).

[330] No. 90-6195 (10th Cir. 8/8/92). The panel originally refused to permit publication of its decision. The court first denied a request to publish its judgement and opinion, rendering it non-citable under Tenth Circuit rules. Third parties involved in *Comeau v. Rupp.*, No. 86-1531-B (D. Kan. 1992), which had relied on *O'Melveny* in ruling that federal common law did not permit the defendants to raise defenses of comparative or contributory negligence, also moved for an order authorizing publication of the *Ferguson* opinion and order. This time the *Ferguson* court relented and decided to order publication. *FSLIC v. Ferguson*, No. 90-6195 (10th Cir. 12/8/92), index reference: 941 F.2d 1213 (1992). See *Back by Popular Demand: CA 10 Publishes 1991 Opinion*, 1(37) Bank Lawyer Liability 6 (1/8/93) (also reproducing, at C-1 - C-13, the full text of the

case, *California Union Ins. Co. v. American Diversified Savings Bank.*[331]

The pertinent *O'Melveny* facts were that, after failure of the savings bank, it became clear that the investors had been misled by bank officers' concealment of the institution's true financial condition. Apparently, the officers also concealed the bank's true financial condition from O'Melveny, the bank's outside counsel, when the firm assisted a subsidiary of the bank in preparing public documents designed to encourage investment in a real estate syndication offered by the subsidiary. The FDIC sued O'Melveny for malpractice for negligent failure to uncover and disclose the institution's weak financial condition.

O'Melveny sought summary judgment and prevailed in district court on the theory that it owed no duty to uncover its client's own fraud and that the FDIC was barred from asserting this fraud against O'Melveny as the fraud was imputed to the FDIC because the agency had stepped into the shoes of the client. The Ninth Circuit disagreed and held that the law firm had a duty to make a "reasonable independent investigation" in order to detect and correct false

---

decisions, opinions and motions).

[331] 948 F.2d 556 (1991). O'Melveny has sought a rehearing en banc because of this apparent inconsistency. In the interim, at least two other district courts have followed O'Melveny (*Comeau v. Rupp.*, ___ F. Supp. ___, 1992 WL 345057 (D. Kan. 10/29/92) (see also *Comeau v. Rupp.*, ___ F. Supp. ___, 1992 WL 397417 (D. Kan. 12/29/92), denying a motion to reconsider); *Federal Savings & Loan Insurance Corp., v. McGinnis, Juban, Bevan, et al.*, _____ F. Supp. ____(No. 89-327, M.D. La. 1992), one circuit court has distinguished it (*FDIC v. Clark*, 978 F. 2d 1541, 1549-51 (10th Cir. Oct. 22, 1992), and the Ninth Circuit itself has refused to extend the application of federal common law to a private action for fraud and negligent representation against an officer of a federal savings and loan association. *Burns International, Inc. v. Western Savings and Loan Association*, 978 F.2d 533 (9th Cir. October 30, 1992). See also *Taylor v. Citizens Fed. Sav. & Loan Ass'n*, 846 F.2d 1320 (11th Cir. 1988). Other courts are currently considering RTC arguments similar to those of the government in *O'Melveny* in other cases involving state-chartered savings and loan associations. These arguments are to the effect that federal common law, and not state law, applies in actions brought by the agency. See *RTC v. Paul*, S.D. Fla., No. 90-1477-CIV-ATKINS, Resolution Trust Corporation's Response to Defendants' Motions to Dismiss, at [illegible] 49, filed on April 10, 1991. The *O'Melveny* case is discussed more fully in Parts I([illegible].) and IV(C)(3) with respect to the professional responsibility issues of a lawyer's duty to investigate and exercise due diligence when it is clear that investors will rely on their work.

Attachment #6 — 9
03-16-93

information in the materials it reviewed. Moreover, the panel found that the FDIC was not precluded from recovering against the law firm by reason of the bank officers' fraud, since the FDIC did not stand in the shoes of the bank as the bank officers who engaged in the fraudulent concealment were not the alter egos of the savings bank (notwithstanding their 100% ownership of the bank's stock) as they were seeking to benefit themselves and not the bank.

In *Ernst & Young*, the Fifth Circuit applied state law in holding that the sole shareholder of a financial institution was as a matter of law incapable of acting contrary to its (i.e., his own) interests and the fraud of the owner was imputed to the bank and to the FDIC as receiver.[332] On November 21, 1992, Ernst & Young settled. The federal banking agencies included as a condition of the settlement agreement a paragraph requiring the accounting firm to consent to the filing of a joint motion to vacate the Fifth Circuit's opinion.[333] The joint motion was, however, rejected by the Fifth Circuit, which refused to vacate its decision.[334]

The question for the legal profession is whether it is fair and just for the federal banking agencies to create federal common law that effectively alters the traditional principles of attorney professional liability for the purpose of "maximizing the asset pool." The Fifth Circuit stated in *Ernst & Young*, for example, that "[n]o statutory justification or public policy exists to treat the FDIC [or any other federal banking agency] differently from other assignees when the FDIC . . . has limited its claim to that of an assignee."[335]

---

[332] *Ernst & Young*, 967 F.2d at 171. The panel left open the possibility that had the FDIC sued in its corporate capacity the imputation issue result might be different. *Id.*

[333] See *Settlement Agreement by and between FDIC, RTC, and OTS and Ernst & Young, United States v. Ernst & Young*, dated November 21, 1992, ¶ 6.

[334] See *Fifth Circuit Conflict: One Panel Preserves* Ernst *Holding, While Another Panel Vacates* Boyar, Norton *Ruling Against RTC*, 1(34) Bank Lawyer Liability Report 2 (1/10/1993). Some lawyers regarded the FDIC's settlement condition as an inappropriate effort to avoid the implications of adverse precedent. They contended that the government essentially tried to "buy off" adverse precedent.

[335] 967 F.2d at 170.

Attachment #6 — 10
03-16-93

The attorney/client relationship is usually within the purview and control of states and their respective judiciaries. As a member of the Working Group has put it,

> lawyers are tested and licensed, or admitted under state law. The Supreme (or highest) Court of the state is responsible for professional disciplinary matters, and both statutory and case law of the sate or states spell out their duties, responsibilities and liabilities. The application of such law provides a framework or construct into which a lawyer's conduct may be analyzed."[336]

It is an area "in which private parties have entered into legal relationships with the expectations that their rights and objectives would be governed by state law standards."[337] The argument can be made, then, that a cause of action for attorney malpractice, and its defenses, should be governed by state law, not federal common law created for the convenience of the regulators.

2. Novel Theories of Attorney Liability in Malpractice Litigation[338]

The seemingly novel malpractice theories all relate to or derive from preexisting and widely-accepted attorney professional obligations. They also parallel or complement theories being espoused by the federal regulators in administrative enforcement proceedings against attorneys as institution-affiliated parties.[339] A brief summary of the more controversial theories follows.

---

[336] Arthur W. Leibold, *Federal Common Law: What and Where? Civil and Criminal Liability of Officers, Directors, and Professionals* (Practising Law Institute, No. 595, 1991).

[337] *Kamen*, 111 S.Ct. at 1717.

[338] This section draws heavily from the CHAIRMAN'S EXPOSURE DRAFT, AMERICAN BAR ASSOCIATION TASK FORCE ON THE LIABILITY OF COUNSEL REPRESENTING DEPOSITORY INSTITUTIONS, **FIRST INTERIM REPORT** Part V (Aug. 3, 1992). [Hereinafter "TASK FORCE REPORT".]

[339] See Part II above.

Attachment #6 — 11
03-16-93

a. The Lawyer's Duty To Investigate and Monitor Compliance with Banking Laws and Regulations

The *O'Melveny* court concluded that, as attorneys practicing in a "high specialty field," O'Melveny had a "duty to guide the thrift as to its obligations and to protect it from liability [which may flow from promulgating a false or misleading offering to investors]."[340] The panel drew by analogy on the securities counsel's obligation to perform a "due diligence" investigation by making a "reasonable, independent investigation to detect and correct false or misleading materials."[341]

A related and largely untested theory of attorney liability invoked by the federal regulators is that a lawyer may be held liable for aiding and abetting officers or directors in the breach of a fiduciary duty these officers or directors hold to the financial institution if the lawyer has *constructive* knowledge of the breach.[342] For example, the FDIC has alleged in *FDIC v. Wise et al.*,[343] that a law firm aided and abetted management in breaching its fiduciary duties by assisting in certain loan transactions that ultimately violated lending regulations. Aiding and abetting law normally requires that the aider and abettor had actual knowledge of the principal's breach of fiduciary duty (or something very close to actual knowledge. The *Wise Complaint*, however, contains language suggesting that the attorneys are being charged with some form of constructive knowledge that might imply a

[340] 969 F.2d at 749.

[341] *Id.* at 749 (citations omitted.) In *FDIC v. Eckert Seamans Cherin & Mellott et al.*, No. 90-0488 (E.D.N.Y., filed Feb. 8, 1990, ¶ 120(h), [hereinafter "*Eckert Complaint*"], one of the claims of malpractice was that the Eckert firm "failed to exercise independent professional judgment on behalf of the bank and its depositors ... ." *Eckert Complaint* ¶ 120(h). The notion that the attorney has an attorney/client relationship with depositors is unusual, and such a suggestion ignores the separate existence of the institution.

[342] Traditionally, attorneys have been sued for violating their fiduciary duty to clients when, for example, they have undertaken multiple representations (e.g., of a bank, its officers, principal shareholders, holding companies, or subsidiaries) which have inherent or which have developed clear conflicts of interest.

[343] No. 90-F-1688 (D. Colo., filed Sept. 21, 1990) [hereinafter "*Wise Complaint*"].

Attachment #6 — 12
03-16-93

much lower standard of awareness on the part of the lawyer.[344]

Some commentators believe that this expansive application of the aiding and abetting to attorney conduct would have troubling implications.[345] The chair of another committee of the American Bar Association has asserted that this aiding and abetting theory

> may establish *sub silentio* an obligation on law firms generally - regardless of the scope of their engagement - to investigate every loan transaction for which the firm is engaged to prepare documentation in order to ascertain whether the loan may violate any one of a large number of statutes and regulations. That the firm may not have been engaged to perform all that work, and that the client may be unwilling to pay for it (or, worse yet, become irritated enough at the thought to sever the relationship), are fundamental issues going to the heart of any duty to investigate.[346]

If the *Wise Complaint* does indeed rely on some form of constructive knowledge as satisfying the scienter requirement for liability as an aider or abettor, the effect could be to expand substantially the investigative responsibilities of attorneys whenever they are engaged to perform

344 Just as in criminal law (from whence the aiding and abetting concept derives), an aider and abettor to a breach of fiduciary duty is held liable as a participant in the fraud itself when the aider and abettor knowingly and substantially assists in the fraud. *Cenco Inc., v. Seidman & Seidman*, 686 F.2d 449, 452 (7th Cir. 1982), *cert. denied*, 459 U.S. 880 (1982).

345 See also Part II(B)(1)(d) above.

346 TASK FORCE REPORT, supra note 338, Part V, at 7-8. It is also worth noting that the American Bar Association's *Statement of Policy Regarding Lawyer's Responses to Auditor's Request for Information* sets forth limitations on the duty to investigate. The policy statement provides in pertinent part that a lawyer's response to an auditor's inquiry "is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation, and where appropriate, legal representation." There is no duty to investigate "legal problems of the client, even when on notice of some facts which might conceivably constitute a legal problem."

legal services for banker clients.[347]

Finally and not insignificantly, by charging under an aiding and abetting theory, the federal regulators may find an additional avenue to that of their federal common law theory for effectively circumventing defenses which have traditionally been available to attorneys in malpractice actions, such as contributory negligence.[348]

b. The Lawyer's Duty to Counsel a Financial Institution on the Prudence and Safety/Soundness of its Business Decisions

The *Wise Complaint* also alleged that Sherman & Howard failed to advise Silverado or its directors that particular transactions were imprudent or unwise. Yet, as the chair of an ABA Task Force has observed, "few attorneys are competent, by either training or experience, to second-guess the business judgments of their clients, but even if it can be shown that a particular attorney had the requisite expertise, the question remains - whence arises the duty to give business advice to the client?"[349]

Many lawyers might be surprised to learn that they should assume responsibility to advise their clients about the safety/soundness

---

[347] Another FDIC complaint which is predicated upon a duty for lawyers to investigate even where no actual knowledge of wrongdoing is present is the complaint in *FDIC v. Bauman et al.*, No. CA3-90-614-H (N.D. Tex., filed Mar. 19, 1990). [Hereinafter the "*Bauman Complaint*".] In that complaint, the FDIC charged the firm with a duty to determine the presence of affiliate transactions and to refuse to close transactions in violation of prohibitions against loans to affiliates. Whether the duty presupposed in this complaint really constitutes a novel extension of existing responsibilities on the part of counsel will, of course, depend on the circumstances proven in the case, including the degree of notice the defendants might have had about wrongdoing by their client. But the assertion of the alleged duty in this case again raises questions about the scope of an attorney's engagement and responsibilities.

[348] The chair of another ABA committee has concluded that "[e]ven with respect to a matter that is unquestionably within the scope of engagement, however, the extent of the inquiry counsel must make ought not to be a rule of general applicability but ought instead to depend upon (A) the nature of the facts within counsel's personal knowledge or professional experience and (B) whether, based on such facts, reasonably prudent counsel should know or suspect that something is amiss." TASK FORCE REPORT, supra note 338, at 10.

[349] *Id.* at 9 (citations omitted).

decisions of their bank clients. It is clear that an attorney may appropriately counsel the client on the broader considerations that are relevant to the narrow legal issue presented to the attorney.[350] Where, however, the client is the supposed expert (as in the case of business judgments and banking prudence) it is by no means clear that the attorney should be expected to develop and volunteer unsolicited advice on those matters. Much will depend on the relative amounts of business judgment and technical law involved.[351]

c. The Lawyer's Duty to Disclose Material Information to Government Regulators and the Public

The attorney's duty is first and foremost to his client. While an attorney clearly cannot knowingly endorse a bank's misleading the government or the public in, for example, an investment offering, the thrust of some of the complaints filed by the federal regulators appears to be that the attorney has a duty to disclose to the regulators and the public investors - i.e. to "the world"[352] - that the client is up to no good.[353] In this regard, the banking regulators appear sometimes to have implied in their suits that an attorney's relationship with his corporate client is analogous to that of a certified public accountant who assumes a public responsibility when he certifies public reports

[350] See the ABA Model Rules of Professional Conduct, Rule 2.1, reproduced in Appendix C below.

[351] Compare the Comment to Model Rule 2.1:

> A client may expressly or impliedly ask the lawyer for purely technical advice. When such a request is made by a client experienced in legal matters, the lawyer may accept it at face value. When such a request is made by a client inexperienced in legal matters, however, the lawyer's responsibility as advisor may include indicating that more may be involved than strictly legal considerations.

See also the discussion in Part IV(C)(4) below.

[352] *O'Melveny*, 969 F.2d at 748.

[353] For possible judicial endorsement of this position, see, e.g., the discussion of the *O'Melveny* decision in Part IV(C)(3)(c) below, at n. 443.

depicting the corporation's financial status.[354]

In *FDIC v. Eckert Seamans Cherin & Mellott et al.*,[355] the FDIC claimed that Eckert failed to advise the Board of Directors of a national bank, inter alia, that an insider was attempting a buy out a subsidiary. The FDIC also claimed Eckert similarly failed to inform the OCC. While it might in some circumstances be appropriate for an attorney to refer the misdeeds of an organizational client's employee to higher authority within the organization,[356] there is no basis in cited law to require the lawyer to notify the regulators (at least where the whole board is not self dealing), and simple resignation always remains an option.[357]

C. Expanded Criminal Liability

Lawyers are also subject to numerous banking-related criminal sanctions. This section concludes Part III with a brief review of those most relevant to banking regulatory practice.

Most of the recently enacted banking statutes are of general application and none of these statutes specifically single out attorneys for special criminal attention or prosecution. However, if interpreted broadly, many if not all of these new criminal provisions could readily be vehicles for the Department of Justice's pursuit of perceived wrongdoing by attorneys in connection with their relationship with failed financial institutions and federal regulatory bodies. A brief

---

[354] "By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times ... ." *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).

[355] No. 90-0488 (E.D.N.Y., filed Feb. 8, 1990).

[356] See, e.g., the ABA Model Rules of Professional Conduct, Rule 1.13(b)(3), reproduced in Appendix C below. Rule 1.13 is discussed in detail in Part IV(C)(5) below.

[357] See further Part IV(C)(2) below.

summary of the criminal law provisions, old and new, relating to bank crimes follows.

FIRREA and "Son of FIRREA"[358] added new bank crimes to the statute books, greatly enhanced penalty provisions for existing crimes, created pretrial forfeiture provisions, instructed the U.S. Sentencing Commission to set bank offense levels high in order to guarantee lengthy sentences for convicted offenders, extended the statute of limitations for many banking offenses to ten years from five, greatly expanded the use of grand jury information in civil and administrative proceedings,[359] and backed up these tough new provisions with a considerable infusion of funds ($162.5 million per year for three years under the Bank Fraud Prosecution Act) into the Justice Department's criminal investigation and prosecution efforts.

Specifically, FIRREA added "bank fraud"[360] as a predicate offense under the Racketeer Influenced and Corrupt Organizations statute.[361] FIRREA also amended the bank agency administrative penalty provisions to augment the crime of "illegal participation" by an institution-affiliated party who knowingly violates a bank agency

---

[358] I.e., the "Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990." [Hereinafter referred to as the "Bank Fraud Prosecution Act."]

[359] 18 USC § 3322(a), provides that a Justice Department attorney who is "privy to grand jury information concerning a banking law violation," either through his duties or pursuant to an order of the court under rule 6(e)(3)(A)(ii), may disclose that information to other Department of Justice attorneys for their use in connection with the new civil penalty provisions and civil forfeiture proceedings enacted by FIRREA. 18 USC § 3322 is a codification of Section 964(a) of FIRREA.

[360] 18 USC § 1344 (Supp. 1991)).

[361] *Id.* § 1961. Pub. L. No. 101-73, § 968, 103 Stat. 506 (1989). The Bank Fraud Prosecution Act enhanced the penalties for bank fraud. Bank Fraud is defined in 18 USC § 1344 as:

> Whoever knowingly executes or attempts to execute, a scheme or artifice (1) to defraud a financial institution; or (2) to obtain any of the moneys, funds, credits, assets, securities, or other property owned by, or under the custody of, a financial institution, by means of false or fraudulent pretenses, representations, or promises, shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

prohibition order.[362] FIRREA also amended an existing obstruction of justice statute to make it a crime for any institution affiliated party to disclose to anyone the fact that the bank had received a grand jury subpoena.[363]

The Bank Fraud Prosecution Act created three new crimes: concealing assets from a conservator, receiver, or liquidating agent of a financial institution;[364] obstructing the examination of a financial institution;[365] and, the financial "kingpin" statute,[366] which provides for life imprisonment and a fine up to $10 million for one who is the organizer or manager of a "financial crimes enterprise."

Both FIRREA and the Bank Fraud Prosecution Act dramatically enhanced penalties for existing crimes: bank bribery;[367] misapplication and embezzlement;[368] false entries in bank records and false statements to influence federally-insured institutions or to obtain loans,[369] mail and wire fraud,[370] and, as noted above, bank fraud.[371]

---

362 12 USC §§ 1786(1) and 1818(j)). The implications of this provision for joint defense agreements is not yet clear.

363 18 USC § 1510(b).

364 *Id.* § 1032.

365 *Id.* § 1517.

366 *Id.* § 225.

367 *Id.* § 215.

368 *Id.* §§ 656 and 657.

369 *Id.* §§ 1005, 1006, 1007 and 1014.

370 *Id.* §§ 1341, 1343.

371 *Id.* § 1344.

Other pre-FIRREA statutes available to prosecutors in bank crime investigations and prosecutions include bank larceny;[372] money laundering;[373] the provisions of the Bank Secrecy Act;[374] RICO;[375] and the obstruction of justice provision relating to obstructing a federal agency proceeding.[376] Another crime of particular concern to the attorney who represents a financial institution before a regulatory agency is the false statements statute.[377] False statements, a general intent crime, makes it a felony to knowingly and willfully misrepresent or conceal a material fact related to any matter within the jurisdiction of a department or agency of the United States. Finally, as with all criminal offenses, the conspiracy[378] and aiding and abetting[379] provisions of the U.S. Code remain available to prosecutors.

---

372 *Id.* § 2113.

373 *Id.* §§ 1956, 1957.

374 31 USC §§ 5311-5326.

375 18 U.S.C. §§ 1961-1968.

376 *Id.* § 1505.

377 *Id.* § 1001.

378 *Id.* § 371.

379 *Id.* § 2.

Kansas Society of
Certified Public Accountants

400 S.W. CROIX STREET / P.O. BOX 5654 / TOPEKA, KANSAS 66605-0654 / 913-267-6460 / FAX 913-267-9278

March 16, 1993

Chairman O'Neal, members of the Committee.

My name is T. C. Anderson, Executive Director of the Kansas Society of Certified Public Accountants.

Lawsuits are surfacing across the country in which those federal agencies charged with watchdogging troubled or failed financial institutions are attempting to hold CPAs and other professionals to a higher standard than the duty of professional responsibility established for a particular profession.

I hope the Committee will take favorable action on SB 355, as amended, which would prevent the holding of CPAs performing accounting, auditing, consulting and other services to financial institutions doing business in Kansas to a greater duty of professional responsibility than required by their professional standards. Louisiana passed such legislation in 1991.

Briefly, let me explain the need for this legislation.

One major provider of CPA liability insurance has shared claim information with me. They report six possible actions against Kansas CPA firms are on file relative to financially troubled financial institutions. No claim has been made against the insured CPA firms at this time and we don't know if any will. We do know, however, in five of the six instances the CPAs had issued a going concern audit report or disclaimed an opinion.

In one case the going concern report had been issued for seven years prior to the institution being placed under the control of the FDIC. In another case five years; three years in another; and in two instances one year. However, those were first time audits.

The sixth possible action resulted from a situation where the Kansas firm did the audit for four years and issued an unqualified opinion. The out-of-state firm which replaced our Kansas CPAs issued the same type of report for three more years before the OTS began to investigate.

In addition, those Kansas CPA firms doing financial institution audits are finding their liability insurance costing more or in some cases non-existent.

A liability plan administered by Rollins Burdick Hunter imposes a 15 to 25 percent surcharge on the premium to those firms doing financial institution audits and the plan administered by Jamison and Company excludes troubled financial institutions from coverage.

If our firms violate Generally Accepted Auditing Standards or Generally Accepted Accounting Principles, they clearly should be held accountable. If they don't, they should not. Banking regulators almost always bring their cases against professionals in federal court, and seek to have federal common law rather than state law apply in such litigation. However, with few exceptions the federal courts have applied state law. Our request would make it clear that if you're covered by state law on day one, someone can't come back on day 200 and say you committed malpractice based on a duty of care you didn't know you had.

This provision hopefully will prevent regulators from seeking to hold CPAs responsible for activities that had nothing to do with providing accounting services to financial institution clients. Hopefully SB 355 will keep the FDIC, RTC or OTS from holding Kansas professionals responsible for business deals that went bad.

To further address the problem facing professions who are associated with failed financial institutions, I hope the Committee will consider an amendment to SB 355 which also is attached to my testimony.

With the passage of each funding bill for the agencies handling the failed institutions, Congress extends the Statute of Limitations for bringing actions. Thus, the six possible cases I described earlier have not been filed. To ensure that the CPAs involved in them are accorded the intent of this legislation, I would ask that SB 355 be made retroactive and that the legislature indicate that this Act is declaration of and codifies existing Kansas law and policy.

Thank you and I'll be happy to stand for questions.

ACCOUNTING TODAY, January 4, 1993

Ernst's S&L Lapses Added To Disaster

By Ken Rankin

WASHINGTON — Accountants at Ernst & Young engaged in a series of improper auditing practices that contributed to the collapse of several large Federally-insured savings and loans during the 1980s, officials at the Office of Thrift Supervision charged.

Documents released by OTS in the wake of E&Y's massive $400 million settlement of those charges allege a long-standing pattern of auditing and accounting standards violations by both of the firm's predecessors — Ernst & Whinney and Arthur Young.

According to the government's complaint, E&Y accountants responsible for auditing a number of failed S&Ls repeatedly violated generally accepted accounting principles and experienced "systemic problems" in complying with generally accepted auditing standards.

As a result of these GAAP and GAAS failures, Ernst & Young's S&L and loan holding company clients were able to "misrepresent and omit material facts" in their reports to Federal banking regulators, OTS charged.

"As a consequence, the savings associations, the savings and loan holding companies and the Federal insurance fund have suffered actual losses in excess of $150 million," the government's complaint said.

Federal regulators attributed some of the allegedly improper auditing practices to inexperience and lack of training for many of the accountants assigned to these S&L audits.

GAAP & GAAS Violations

In a formal notice outlining the government's charges, OTS alleged several major areas of professional standards violations by Ernst & Young ranging from improper recognition of income to a failure to require "material and necessary" disclosures of transactions.

Within those broad problem areas, OTS detailed a dozen separate claims for relief against E&Y, each one illustrated with specific examples of GAAP and GAAS violations during the firm's audits of four failed thrifts:

- Vernon Savings and Loan of Dallas;
- Denver's Silverado Banking S&L;
- Western Savings Association of Phoenix; and
- Irvine, Calif.-based Lincoln Savings and Loan.

According to OTS, there are four areas Ernst & Young went wrong:

1) Improper recognition of income due to improper accounting for losses.

- Improper Joint Venture Loss Accounting — by E&Y predecessor Ernst & Whinney during the firm's audit of Silverado's 1984 and 1985 financial statements.
- Failing to Provide Adequate Allowances for Loan Losses — during Arthur Young's audits of Vernon S&L during the early 1980s.
- Placing Unwarranted Reliance on Appraisals — in connection with E&W's Silverado audit, as well as AY's audits of Vernon and the Western Savings Association.

2) Improper recognition of income from transactions.

- Improper Recognition of Income from Purported Sales of Real Estate — in connection with the audit of Lincoln S&L's 1986 and 1987 financial statements by Arthur Young.
- Improper Accounting for Exchanges of Assets — during that same Lincoln audit.
- Improper Accounting for Acquisition, Development and Construction Arrangements — during AY's 1983, 1984 and 1985 audits of Vernon.
- Improper Recognition of Loan Fee Income — in Vernon's audited financial statements.
- Improper Accounting for Mergers and Business Combinations — again during Arthur Young's audits of the Vernon S&L.

3) Failure to disclose transactions in audited financial statements when disclosure was material and necessary

- Failure to Disclose Transactions with Related Parties — in connection with AY's audit of the Western Savings Association during the mid-1980s.
- Failure to Disclose Transactions with Major Customers — during the audit of Lincoln's 1987 financial statements.
- Accounting for Troubled Debt Restructuring — which was conducted improperly by AY in connection with the firm's audit of Western Savings.

4) Failure to conduct audits in accordance with the requirements of generally accepted accounting practices.

- Repeated GAAS Noncompliance — by both Arthur Young and Ernst & Whinney during the audits of Silverado, Western and Vernon.

Terms of the Deal

- ▲ $271,760,000 in cash to the Federal Deposit Insurance Corporation to resolve the government's claims against the firm.
- ▲ An additional cash settlement of $128,240,000 to the Resolution Trust Corporation.
- ▲ A "consent cease and desist order" with the Office of Thrift Supervision obliging E&Y to provide additional training and experience in relevant areas to all auditors assigned to insured depository institutions.
- ▲ A separate OTS requirement that the firm establish special new internal quality controls and external third party reviews of the work of audit partners.
- ▲ An agreement by E&Y to comply with professional standards and to provide documentation and heightened review of accounting decisions in "sensitive areas."
- ▲ A series of additional Federal orders requiring the firm to perform audits according to accepted standards, to undertake additional professional training of its auditors, to base audit decisions on competent evidential matter and to ensure the personal review, approval and signing of audits by E&Y partners.
- ▲ An agreement prohibiting two former E&Y partners (Jack Atchison and Edward F. Flaherty) and one current partner (George Derr) from performing work for insured financial institutions in the future.

Source: OTS

3

As Amended by Senate Committee

Session of 1993

SENATE BILL No. 355

By Committee on Judiciary

2-17

AN ACT concerning ~~certified public accountants; relating~~ ~~to~~ *the* duty of professional responsibility to financial institutions *of certified public accountants and attorneys.*

Be it enacted by the Legislature of the State of Kansas:

Section 1. *(a)* Unless otherwise agreed in writing, certified public accountants, licensed in accordance with article 3 of chapter 1 of the Kansas Statutes Annotated, and their firms, officers, directors, agents, servants and employees, while acting in the course and scope of providing accounting, auditing, consulting and other professional services to financial institutions authorized to do business or doing business in the state of Kansas, shall have no greater duty of professional responsibility to the institution, its shareholders, depositors, customers, creditors or insurers than that required of certified public accountants by generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) as provided by K.A.R. 74-5-202 and 74-5-203 and amendments thereto.

(b) Unless otherwise agreed in writing, attorneys licensed to practice law in this state and their firms, including employees thereof, acting in the course and scope of providing legal services to financial institutions authorized to do business or doing business in the state of Kansas, shall have no greater duty of professional responsibility to the institution, its shareholders, depositors, customers, creditors or insurers than that required of attorneys under state law.

Sec. ~~2.~~ 4. This act shall take effect and be in force from and after its publication in the statute book.

Sec. 2 This act is declaratory of and codifies existing Kansas law and policy.

Sec. 3 This act shall apply to all past, present and future claims or causes of action based on Kansas state law seeking to recover money damages from any person or entity covered within the scope of Section 1 which are filed in any court of competent jurisdiction.

Attachment #7 — 5
03-16-93

TESTIMONY OF WILLIAM Q. MARTIN
General Counsel and Trust Officer

THE SMITH COUNTY STATE BANK & TRUST COMPANY
136 S. Main
Smith Center, Kansas 66967
(913) 282-6682

March 16, 1993

To: House Judiciary Committee
Mike O'Neal, Chair

Re: Senate Bill 121

Good afternoon:

My name is Bill Martin. I am General Counsel and Trust Officer for The Smith County State Bank & Trust Company, Smith Center, Kansas. My appearance today is at the request of the Kansas Bankers Association, Trust Division.

I handle tax and legal matters that affect trusts and wills for which The Smith County State Bank & Trust Company serves in a fiduciary capacity. In my position, I also direct, review and administer investments held by The Smith County State Bank & Trust Company as a trustee or other fiduciary position.

K.S.A. 17-5004 is a state statute (originally enacted in 1949) as a codification of the "prudent man rule" which is the cornerstone for investment standard by Kansas fiduciaries. Senate Bill 121 is a proposed amendment to this statute and is intended to implement standards for investment of assets held in a fiduciary capacity that follow what is termed "modern portfolio theory".

The Prudent Man Rule was adopted by statute or case law in most American jurisdictions to replace the old and restrictive "legal list" statutes which gave specific lists of which investments were per se prudent.

However, the intended purpose of the prudent man rule has been lost as it has been interpreted by various court decisions on a case by case basis. Various cases were treated as precedents establishing general rules which resulted in specific case results and flexible principles becoming crystallized into specific rules prescribing the types and characteristics of permissible investments. Therefore, based on some degree of risk that was perceived in the abstract to be excessive, broad categories of investments came to be classified as "speculative" and imprudent per se.

The old Prudent Man Rule also has an inherent difference and basic conflict with what is termed "modern portfolio theory". Because investment information and theory concerning financial markets have changed over the time, the actual practice of progressive Kansas fiduciaries has also changed. Senate Bill 121 simply codifies what is the actual investment philosophy and practice of investment management as practiced today by Kansas fiduciaries.

Senate Bill 121 is based on The Prudent Investor Rule as developed by the American Law Institute (ALI) and is similar to the investment statue recently adopted by Illinois; the statute is also under consideration in New York and Florida. Six other states (California, Delaware, Georgia, Tennessee, Minnesota and Washington) have previously enacted their own "modern" versions of the Rule.

HOUSE JUDICIARY
Attachment #8
03-16-93

Senate Bill 121 makes five fundamental alterations to criteria for prudent investing.

1. The standard of prudence is applied to the portfolio as a whole rather than each individual investment reviewed in isolation.

2. A risk and return analysis is the basis for investment decisions, rather than an absolute prohibition against risk taking or speculation.

3. The duty to diversify is considered of such central importance that it is specifically incorporated into the rule.

4. No investment or category of investment is proscribed.

5. The delegation of investment functions is permitted subject to certain safeguards.

The new Act emphasizes risk management rather than risk avoidance. Modern experience with inflation dictates a greater sensitivity to the needs of today and tomorrow.

Many of the familiar concepts of the former rule continue to apply.

---- The fundamental duty of loyalty and impartiality

---- Trustee must exercise reasonable care, skill and caution

---- Trustee has the duty to diversify investments unless there is a good reason not to do so

---- Prudence involves a standard of conduct and not of performance

Senate Bill 121 also underscores the duty to incur only reasonable and appropriate costs. The proposed legislation also allows, but does not require the fiduciary to consider related trusts and assets of beneficiaries when making investment decisions.

As mentioned earlier, Senate Bill 121 closely follows the Illinois version of the act with some other small changes. A brief summary of the **differences** from the ALI Rule follows:

a. <u>Expansion on original asset rule</u>: The purpose of this language (page 2, lines 20 - 24) is to allow the fiduciary to retain certain assets (such as farmland or a closely held business) that might not otherwise be considered as "proper" assets for investment purposes.

b. <u>Expansion on the delegation of investment responsibility</u>: Although there is a general rule not to delegate fiduciary responsibility to others, this bill will allow for such delegation to another fiduciary, or to an agent, if certain required steps are followed (see page 3, lines 26-43 and page 4, lines 1-19).

c. <u>Increases emphasis on the exercise of business judgment rule</u>: See page 2, lines 6-11.

This bill has some addition language that is not covered in the Illinois version of the ALI Rule:

1. Limitation of Investments for Conservatorship: Defers to K.S.A. 59-3019 when investing funds for a conservatorship. Due to the special nature of a conservatorship, the fiduciary is held to the types of investments specified under K.S.A. 59-3019 unless a specific court order allow otherwise.

2. Retained portion: This bill retains some of the basic administrative provisions from existing K.S.A 17-5004.

Senate Bill 121 is not a radical departure from the current law, but does afford greater flexibility in making investment decisions to enhance yield and value for the benefit of clients of a Kansas fiduciary.

I support the enactment of Senate Bill No. 121.

Thank you.