Some of the Things Every Director of a California State-Chartered Bank Should Know

Statutory Duties of a Director

- All provisions of laws applicable to corporations generally apply to banks, including the General Corporation Law. Financial Code §101
- **Duties of directors (fiduciary duties & duties of care) are set forth in California Corporations Code §309.**
  - Duties must be performed in "good faith"and in the "best interests" of the corporation,
  - with the care of an "ordinarily prudent person"
    - in a "like position"
    - under "similar circumstances"
    - including "reasonable inquiry"

Statutory Duties of a Director-continued

- Elimination of liability through performance of duties. Corp.Code § 309(c).
- Elimination or limitation of liability for money damages through a provision in the Articles of Incorporation. Corp. Code § 204(a)(10).
  - **Caveat: The Sarbanes-Oxley Act of 2002** (Sarbanes Oxley Act) codifies corporate governance "best practices" and may create **new duties** under state and federal law. **The Sarbanes Oxley Act is applicable to"public companies."**

How DFI Views Directors

- **Integral Part of Bank Management**
- **Oversee Operations**
  - Adopt policies to guide management.
  - Delegate authority to board committees and officers.
  - Review and approve all actions so delegated.
  - Appoint an audit committee composed only of outside directors (subject to FDIC exemption authority).
- **Corporate Governance**
  - represent shareholders
  - other stakeholders

Some Basic Corporate Governance Requirements

- **Banking Law, General Corporation Law, and Federal Deposit Insurance Act**
  - Board must have at least 5 and no more than 25 members. Financial Code § 680.
  - Meetings must be held at least once per calendar quarter (statutory minimum). Financial Code § 683.
  - Telephone meetings are permitted. Corp.Code § 307.

  - Each board of an insured bank is required to appoint an audit committee composed only of outside directors, to whom the internal auditor and outside auditors will report directly. 12 U.S.C.§ 1831m(g). There are exemptions from this requirement, as may be determined by the FDIC, including the following:

Some Basic Corporate Governance Requirements - Continued

  - If an insured bank can show hardship under the criteria of 12 U.S.C. § 1831m(g), the FDIC may exempt it from this requirement.
  - If the insured bank has less than $150 million in total assets, or other FDIC minimum, the bank is not subject to 12 U.S.C. § 1831m. See the “Exemption for Small Depository Institutions” in 12 U.S.C. § 1831m(j).
- Management is responsible for financial statements, internal controls, and an annual independent audit of financial statements is required, subject to the FDIC exemption authority previously referred to. 12 U.S.C.§ 1831m.
- “Large bank” audit committees, as defined by the FDIC, are required, among other things, to have access to the **audit committee’s own outside counsel.** 12 U.S.C. §1831(g)(1)(C)(ii).

Some Basic Corporate Governance Requirements - Continued

- **New Corporate Governance Requirements**
  - **Sarbanes Oxley Act (Effective July 30, 2002---Amends provisions of the Securities Exchange Act of 1934 in 15 U.S.C. § 78a et seq.)**
    - **Applicability of Sarbanes Oxley Act to Banks. The Act amended Section 12(i) of the Securities Exchange Act of 1934 to make it clear that the federal banking agencies have the authority to administer and enforce the various provisions of the Act applicable to banks which are public companies.**
      - "Public companies" mean all SEC-reporting companies (§ 2(a))
        - » Includes banks and bank holding companies which are public companies. Excludes banks which are wholly-owned subsidiaries of bank holding companies and other wholly-owned affiliates of bank holding companies or banks.
      - Each board of an insured bank (or its holding company) which is also a "public company", must comply with the additional applicable provisions of the Sarbanes Oxley Act as well as with the Federal Deposit Insurance Act with respect to audits, audit committees, and other financial management requirements.

Some Basic Corporate Governance Requirements - Continued

- **New Corporate Governance Requirements**
  - **Sarbanes Oxley Act(con’t)**
    - Public Company Audit Committee Requirements (§ 301):
      - » Audit committee must consist of “independent” directors (“Independence” defined to prohibit acceptance of any consulting, advisory or other compensatory fees from the company or being an affiliated person of the company, or a subsidiary thereof, subject to the exemption authority of the SEC and the federal banking agencies).
      - » Audit committee is responsible for any registered public accounting firm hired by the company.
      - » SEC must issue rules requiring **disclosure** of whether a company’s audit committee includes at least one **“financial expert”(**auditing experience and knowledge of GAAP) as defined in the statute. (§ 407).
  - The ban on loans to executive officers and directors in § 402 does not apply to FDIC insured banks if the loan, as defined in the Federal Deposit Insurance Act, is subject to the insider lending restrictions of § 22(h) of the Federal Reserve Act. 12 U.S.C.§ 375b.

Some Basic Corporate Governance Requirements - Continued

- **New Corporate Governance Requirements**
  - **California Corporate Disclosure Act (Effective January 1, 2003---Amends Corp. Code §§ 1502 and 2117)**
    - **Requires every corporation to file a statement annually with the Secretary of State, including:**
      - Names and addresses of directors;
      - Number of vacancies on the board.
    - **Requires every "publicly traded company" to file a statement with the Secretary of State. "**Publicly traded company" means a company with securities traded on a national or foreign exchange, or is the subject of two way quotations that are regularly published. The statement should include:
      - Name of the company's independent auditor and a description of the services provided;
      - Annual compensation paid to each director and executive officer;
      - Description of any loans made to any director at preferential rates;
      - Whether any bankruptcy has been filed by directors or executive officers in the past 10 years.

Potential Liability

- CIVIL LIABILITY
  - **LIABILITY FOR UNAUTHORIZED ACTS UNDER THE BANKING LAW**
    - **ILLEGAL DISTRIBUTIONS. Financial Code § 687**. The Commissioner may bring an action against director(s)of the bank on account of the making of a distribution contrary to Financial Code § 640 et seq.
    - **ILLEGAL LOANS. Financial Code § 688**. The Commissioner may bring an an action against director(s) of the bank on account of the making of an illegal extension of credit.

Potential Liability- continued

- **CRIMINAL LIABILITY AND MONETARY PENALTIES**
  - **LIABILITY FOR VIOLATIONS OF PROHIBITED PRACTICES PROVISIONS FOUND IN FINANCIAL CODE §§ 3350 et seq. AND 3370 et seq. INCLUDING PROHIBITIONS AGAINST:**
    - Gratuity or personal benefits received in exchange for bank services (felony). Financial Code § 3350.
    - False statements, false entries in books or records (felony). Financial Code § 3368.
    - Misapplication of bank assets or credit (felony). Financial Code § 3361.
    - Prohibited Loans to Directors, Executive Officers and Principal Shareholders (felony and monetary penalties). Financial Code § 3376. (The ban on loans to directors and executive officers contained in the Sarbanes Oxley Act does not apply to FDIC insured banks and thrifts that are subject to the existing insider lending restrictions of the Federal Reserve Act).

Key Provisions of the Banking Law

- FC §§ 406 and 622. Organizational and pre-opening expenses
- FC §700 et seq. Acquisition of Control
- FC §1220, 1221, 1336. Lending limits and Investment limits
- FC §3354. Purchase or lease of any real or personal property from a director
- FC §3355 & 3356. Sale of bank assets to insiders
- FC §3359. Loans secured by stock of bank or its holding company prohibited
- FC § 3372. Prohibited loans to insiders (“Officers and Directors”)

Note: Please confer with the bank's legal counsel regarding the provisions of law covered in this presentation.

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