THE LEGAL ISSUE | MAY 2015

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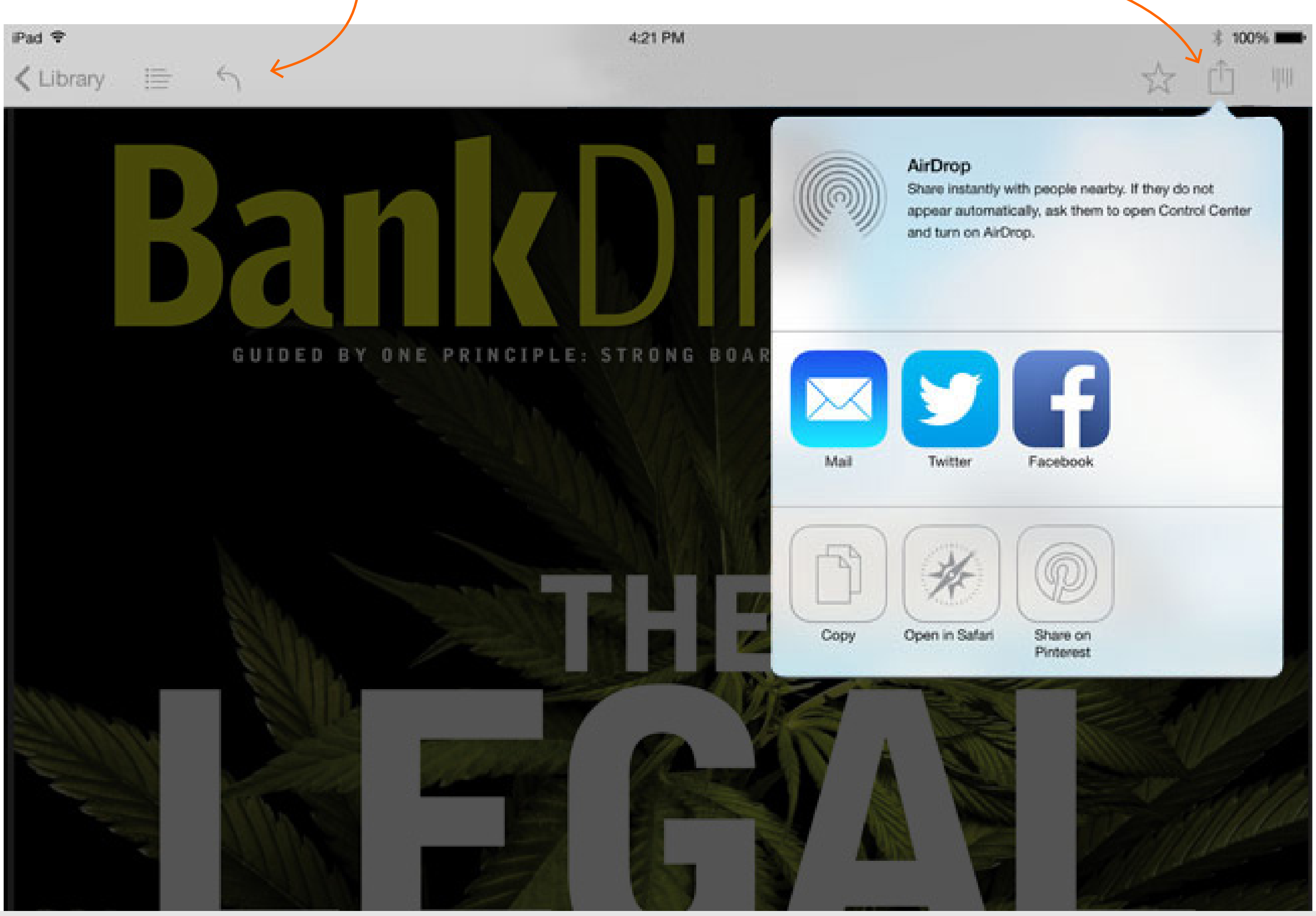

DIGITAL MAGAZINE

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BANK DIRECTOR MAGAZINE GOES MONTHLY

The year was 1991. Banks were reeling from a credit crisis. Neil Bush, the son of a sitting president and a director of a failed savings and loan, was on the cover of the first issue of a magazine whose purpose was informing members of bank boards on "the serious business of being a bank director." In a letter to readers from *Bank Director*'s first editor, Tom Wood, he says: "In today's banking environment, the uninformed director slows the growth of the bank and puts at risk his own net worth." Some things don't change. Now in its 24th year of publication, *Bank Director* magazine has seen periodic credit crises lead to hundreds of bank failures. In the wake of each crisis have come more regulations for banks. The magazine's philosophy about the importance of an informed board remains no less critical today. But it's not just personal liability that makes serving on a bank board a scary proposition. Regulators expect more these days from bank boards, both in terms of knowledge of the bank's business and in providing a credible challenge to management. *Bank Director* magazine seeks to meet the challenge by increasing the amount and accessibility of information it provides. In contrast to many publications across the country, which are shrinking in size and in frequency, *Bank Director* is going the other way. We're becoming a monthly publication. We will continue to publish a print magazine quarterly, just as we have for a quarter century, but will now publish eight additional issues per year available as an app for your tablet or

Naomi Snyder is managing editor for *Bank Director* and editor of the digital issues.

SWIPE UP

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Naomi Snyder | nsnyder@bankdirector.com

BANK DIRECTOR MAGAZINE GOES MONTHLY

quarterly, just as we have for a quarter century, but will now publish eight additional issues per year available as an app for your tablet or mobile device. This first digital issue focuses on legal and compliance issues in banking. Subsequent issues will focus on topics such as attracting top talent and on compensation, growing the bank, serving on the audit or risk committees, handling governance, and overseeing technology. This new digital version is a downloadable app that takes full advantage of the interactivity enabled by mobile devices. We can embed videos, run slideshows, take polls of our readers, and open up additional windows of information through a touch on a screen. This is an exciting time for *Bank Director* as we continue to grow and provide information for the "serious business of being a bank director."

Naomi Snyder is managing editor for *Bank Director* and editor of the digital issues.

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Gone are the days when a board and its CEO could focus almost exclusively on strategy and making money. With the changing regulatory environment, bank executive teams and boards are spending more time on legal and compliance issues in banking. The following is a brief compilation of what's ahead in banking law, liability and compliance that you need to know as a member of a bank board.

Lisa Valentine is a freelance writer in Saratoga Springs, New York.

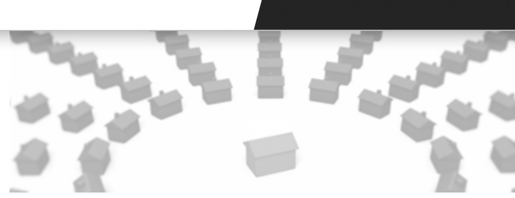
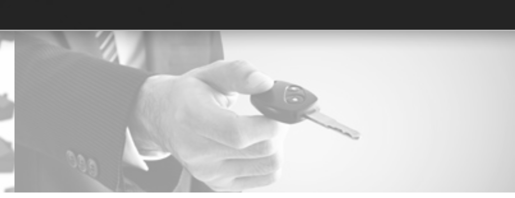
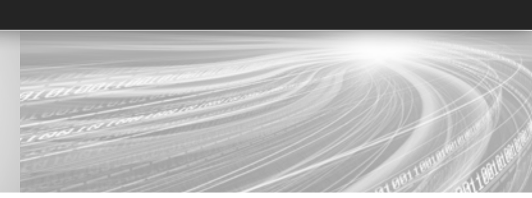
Tap the numbered icons to cycle through topics

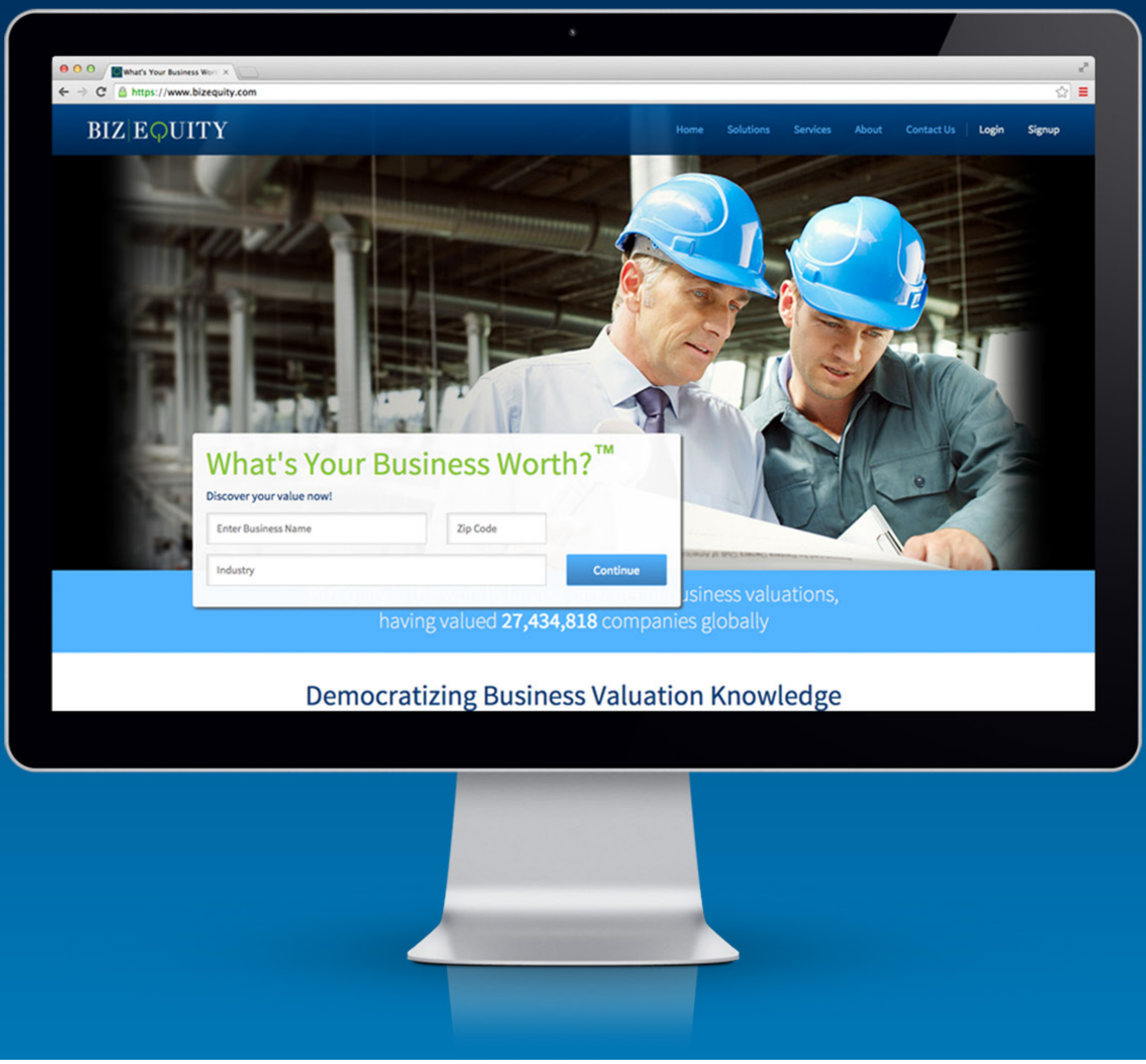
1 2 3 4

LIABILITY SHIFTS TO RETAILERS

To improve fraud protection, U.S. credit card companies will adopt the EMV (Europay, Mastercard, Visa) technology, which uses a built-in microprocessor chip. Each transaction creates a unique identifying number, so criminals can no longer steal just a credit card number in order to make fraudulent purchases. In October, 2015, banks are liable for fraudulent transactions if they have not issued EMV cards

PULL UP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BANKING ON MARIJUANA

The marijuana industry is growing as more states legalize the drug. Is there a way to safely bank these businesses?

BY **NAOMI SNYDER**

Matt Walstatter and his wife Meghan are purveyors of dope. But they pay their taxes, follow the rules and are doing so in a state where medical marijuana sales are now legal, Oregon. "Our focus is on running a legitimate, compliant business," Matt Walstatter says. Their problem has been finding the financial services they need to run their business, pay their bills, pay their taxes and operate as if they weren't criminals. At least 10 banks either rejected them or closed their accounts on finding out they were marijuana retailers. "It's publicly known [these businesses] deal in large amounts of cash," says Taylor West, deputy director of the National Cannabis Industry Association in Colorado. "It makes these businesses sitting ducks for robberies and other kinds of crime. There is a real concern that this situation won't be taken seriously until someone gets killed."

Few banks are willing to even offer a deposit account to a marijuana business in the growing number of states where marijuana is now legal, and even fewer are willing to speak publicly about doing so. Marijuana is still illegal at the federal level, and banks and their officers and directors could face criminal prosecution for violating the Bank Secrecy Act, which requires financial institutions to report suspicious activity that might signify money laundering or other criminal activities. The U.S. Department of Justice and FinCEN, an arm of the U.S. Treasury Department which enforces the Bank Secrecy Act, have issued guidance clarifying their positions on prosecuting marijuana businesses and the entities that serve them, but that has done little to swing the financial doors open for an industry estimated to have generated $2.7 billion in legalized sales in 2014.

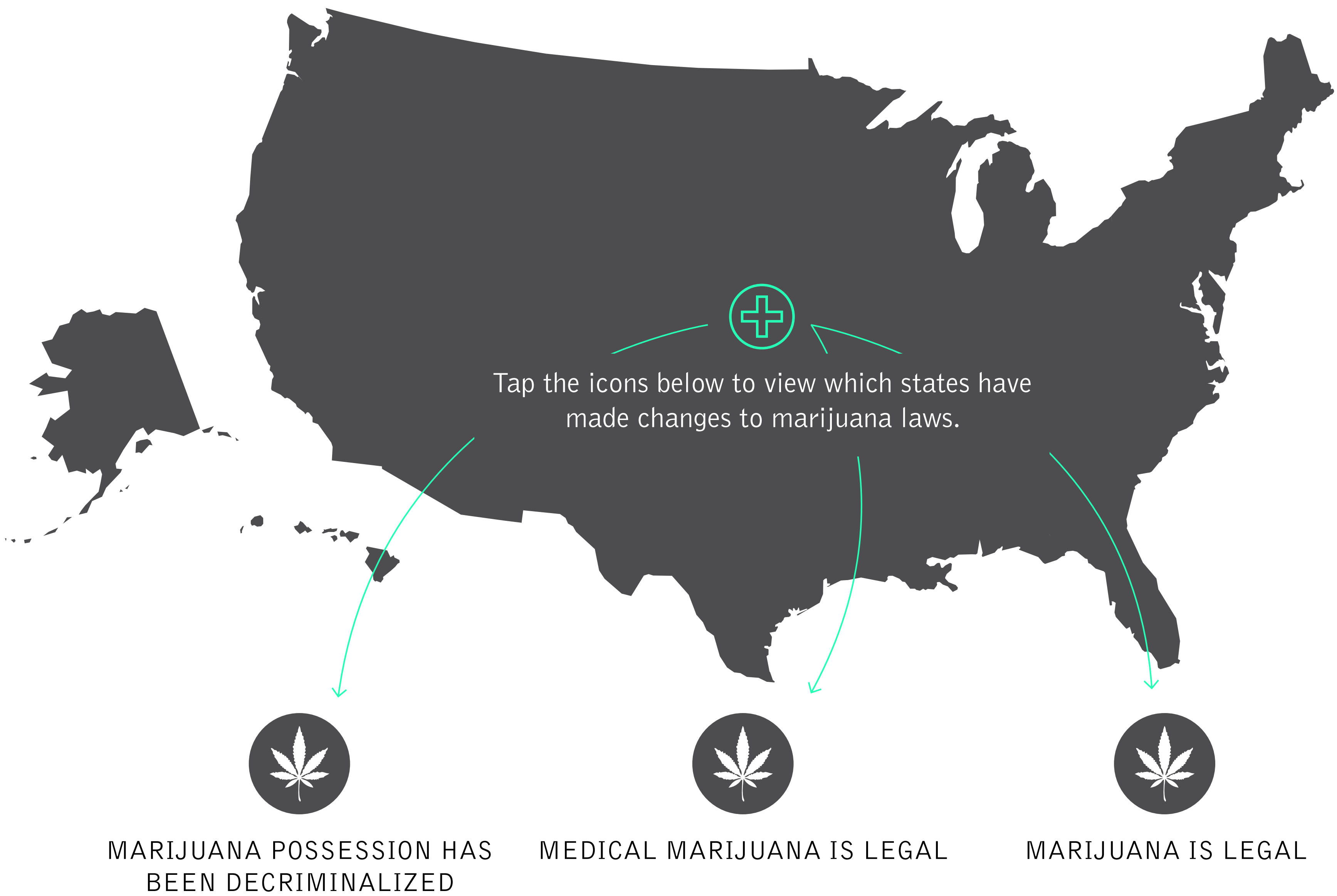
$2.7 BILLION

2014 ESTIMATE OF LEGAL MARIJUANA SALES NATIONWIDE, THE ARCVIEW GROUP

Twenty-three states and the District of Columbia allow medical use of marijuana and four states and the District of Columbia have passed laws allowing for recreational use among adults. Two of them, Colorado and Washington, have implemented a commercial structure for the sale of marijuana. California's municipalities all regulate medical marijuana businesses their own way. But few banks want to have anything to do with those new

MARIJUANA LAWS BY STATE

Source: Marijuana Policy Project



commercial businesses, leading to a strange legal no man's land. Marijuana retailers and growers are shunned by financial institutions, so they can't handle credit card transactions, can't wire taxes to the appropriate government agency, or pay bills without sending their employees out with paper bags stuffed with cash, just hoping they don't get robbed. Is there a way to safely bank these businesses? That depends on your tolerance for risk and your ability to manage your bank without going up in smoke.

One of the few organizations publicly upfront about banking the marijuana industry, MBank, a $162 million asset, state-chartered bank in Gresham, Oregon, just outside Portland, plans to quit serving the industry

at the end of June. "Compliance was a lot bigger than we obviously thought," says CEO Jef Baker. "My feeling is that it would have to be a larger bank that could effectively run a compliance program." For now, Oregon is a medical marijuana state, but the law will allow recreational use for everyone over the age of 21 by July of this year, with commercial recreational sales expected to start in 2016. The 20-year-old MBank, jokingly nicknamed "marijuana bank," also announced plans earlier this year to expand in Colorado, but nixed plans later. With just three branches, Baker said the bank didn't have the infrastructure to meet the overwhelming demand.

Other institutions also are trying to bank the industry while limiting their risks. Numerica Credit Union in Spokane, Washington, will only bank licensed growers and processors, not licensed retailers, and won't let them use remote deposit capture, credit cards, night deposits, mobile banking or online bill pay. Don Childears, president and CEO of the Colorado Bankers Association, estimates that eight banks are providing services in his state to marijuana business, but only with longstanding clients, as the state's voters approved medical marijuana in a referendum 15 years ago. None of the banks want their names public, he says. Their regulators have allowed them to continue to serve those businesses, as long as they don't try to expand their marijuana clientele, he says. "Our one piece of advice is don't go into this field until you get a green light from your legal counsel," Childears says. "I frankly don't know of an attorney who would tell you to go into this business. It's quite a mess, but honestly, it's [Colorado's] mess. "

"OUR ONE PIECE OF ADVICE IS **DON'T GO INTO THIS FIELD UNTIL YOU GET A GREEN LIGHT FROM YOUR LEGAL COUNSEL."**

— DON CHILDEARS, PRESIDENT AND CEO OF THE COLORADO BANKERS ASSOCIATION

The Department of Justice's guidance in February 2014 for marijuana-related financial crimes did little to alleviate Childears' concerns. The guidance, called the Cole memo, says the department would focus prosecution on businesses that violate eight principles, such as selling to minors or doing business with illegal drug cartels. Plus, the Department of Justice made it clear that financial institutions could be prosecuted for violations of the Bank Secrecy Act if they fail to follow proper due diligence regarding the Department of Justice's enforcement prior-

“THE REGULATORY POSITION IS NON-OBJECTION.
IT’S NEVER APPROVAL.”

— **JEF BAKER,**
CEO OF MBANK, A STATE-CHARTERED BANK IN GRESHAM, OREGON

ities. FinCEN simultaneously issued guidance, reiterating that marijuana still is illegal under the Controlled Substances Act, and directing banks to file Suspicious Activity Reports (SARs) on marijuana businesses even in states where it’s legal, as well as conduct proper due diligence on customers who are engaged in the marijuana industry. The American Bankers Association in a memo warned members that the expectations set forth in the guidance “are extensive and require financial institutions to adopt procedures to closely scrutinize all activities of a marijuana business.”

Chris Myklebust, the commissioner of the Colorado Division of Financial Services, which regulates credit unions, says the state is slowly beginning to see banks and credit unions tiptoe into the industry. He recommends that financial institutions do an extensive risk assessment before banking the marijuana industry, including assessing the reaction of shareholders and customers. Childears says he got a call from a shareholder of a bank threatening to sue because the bank hadn’t disclosed its plans to bank the marijuana industry to its investors. Regulators’ input also is needed. Clients should sign affidavits that they aren’t violating any of the principles of the Justice Department’s Cole memo, Myklebust says.

MBank got its clients to sign affidavits and checked with its regulators before banking the business. “The regulatory position is non-objection,” Baker says. “It’s never approval.” The board did its own research and constructed a plan to mitigate its risks, hiring three extra employees just to conduct Bank Secrecy Act-related due diligence on the new customers. "It's a long row to hoe," he says. "It almost took us a year just to become knowledgeable enough, developing a program from scratch where none exists." In order to pay for the extra employees, marijuana-related businesses are charged a start-up fee and a monthly maintenance fee, which varies based on the size of their business. Walstatter and his wife were paying MBank $1,000 per month for a checking account. MBank had 70 marijuana businesses as of mid-April. But despite the sizable income possibilities, it wasn't enough. Baker says regulators never told him to shut down the business. But his bank's story shows the complexity of handling a nuanced regulatory position. What will it take for more banks to be comfortable in the increasing number of states allowing for marijuana sales? Until Congress changes the federal law, it may not be very many, according to Childears and West. Congress could allow banks to provide services in states where marijuana is legal, but not legalize marijuana across the whole country. So far, all such proposals in Congress have been nipped in the bud. **|BD|**

Naomi Snyder is managing editor for *Bank Director* and editor of the digital issues.

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Fair Lending Compliance Is Becoming More Complex and More Challenging

By **Paul R. Osborne**, **Reid S. Simon** and **Niall Twomey**

Compliance with fair lending regulations has become dramatically more complex over the past several years. Although the underlying regulations have been in place for decades, monitoring by the Consumer Financial Protection Bureau's (CFPB) Office of Fair Lending and Equal Opportunity, coupled with vigorous enforcement by the U.S. Department of Justice (DOJ), have increased lenders' risk factors substantially.

Fair lending forbids discrimination based on "prohibited basis" factors: race, religion, ethnicity, national origin, gender, marital status, age, familial status, disability, receipt of income from public assistance sources, and the applicant's exercise of rights under the Consumer Credit Protection Act. Problems can arise when lenders fail to monitor risk factors:

- Underwriting. Lenders need to monitor and document any disparities in underwriting outcomes based on a prohibited basis as well as any inequitable application of exceptions to underwriting policies.
- Pricing. Statistically significant differences in interest rates, fees, or other characteristics offered to applicants by prohibited basis create pricing risk.
- Steering. It is illegal to steer members of a prohibited basis class to less favorable—often more costly—loan products. Offering similar if not identical products with different pricing through different business units can have the same effect as steering.
- Servicing. Once all the loan documents have been signed and the customer is on board, posting of loan payments or waiving of late fees needs to be done equitably across a client base.
- Redlining. Lenders need to be careful when analyzing where their customers live to avoid unintentionally redlining, which involves drawing red lines on a map around neighborhoods where lenders do not want to do business.

Enforcement Trends

In February 2010, the DOJ established the Fair Lending Unit to focus on potential

CONTINUE READING

Fair Lending Compliance Is Becoming More Complex and More Challenging

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Enforcement Trends

In February 2010, the DOJ established the Fair Lending Unit to focus on potential abuses in the consumer lending sector. Since then, the DOJ has filed or resolved 36 lending matters under the Equal Credit Opportunity Act, the Fair Housing Act, and the Servicemembers Civil Relief Act. Settlements have provided more than $1.2 billion in relief for affected communities and individual borrowers.

Although much of this money came from settlements with major lenders, in 2013 the DOJ reached settlements with four community banks that each had less than $400 million in assets. Many of these settlements—large and small—involved pricing discrimination against minority borrowers.

Proposed HMDA Reporting Requirements

On July 24, 2014, the CFPB issued a proposed rule for the expansion of data that lenders need to report under the Home Mortgage Disclosure Act (HMDA). The CFPB wants to use HMDA data to increase awareness of the housing market and, more broadly, the availability of credit. The most significant changes to the HMDA would include:

- Mandatory reporting of home equity lines of credit (HELOCs) and reverse mortgages
- Quarterly reporting for large institutions
- Changes to reporting thresholds—a 25-loan minimum for depository institutions
- Inclusion of an additional 37 data fields, some of which involve qualitative factors, expanded borrower data, or items related to qualified-mortgage and ability-to-pay rules

Banks and their boards can begin to prepare for the changes by discussing the following questions:

- How do we currently collect HMDA data?

CONTINUE READING

Fair Lending Compliance Is Becoming More Complex and More Challenging

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- How do we currently collect HMDA data?
- Can our existing staff collect and record the required data values?
- What steps are the developers of the mortgage application or underwriting system that we use taking to prepare for the changes?
- Do individuals responsible for potentially newly covered areas such as HELOCs and reverse mortgages have sufficient experience with the HMDA?
- Have we conducted data reviews to confirm accurate recording of HMDA data?
- Are we prepared for the potential implications of the new data disclosures? Regulators, consumer rights organizations, advocacy groups, competitors, and others will be looking at HMDA data.

Raising the Ante on Compliance

Compliance with fair lending regulations requires a greater focus on data integrity and the ability to manage statistical models than in prior years. Lenders that have not yet made the investment in internal and external resources to handle the new, expanded and increasingly sophisticated tasks need to consider steps to remain competitive in a challenging marketplace.

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CONTINUE READING

The New CHIEF OF COMPLIANCE

CHIEF COMPLIANCE OFFICERS HAVE A MORE IMPORTANT ROLE TO PLAY THAN EVER BEFORE.

by **John Engen**

Art Heise became chief risk officer of Associated Banc-Corp in 2011, and less than a week later regulatory examiners began talking to him about the Green Bay, Wisconsin-based company's anti-money-laundering problems.

A few months after that, the Office of the Comptroller of the Currency (OCC) slapped $27 billion asset Associated with a consent order and civil money penalties for deficiencies in its Bank Secrecy Act compliance program.

It took nearly three years for Heise to work Associated out of the regulatory penalty box, leaving one board member last summer to wonder aloud about the job's appeal. "He said, 'You know, Art, we were talking about you last night and we think you have the worst job at the bank,'" Heise recalls.

"But I find the job exciting," he adds. "I can be working on ALCO one minute, credit risk the next and then investment services. I wake up each morning not knowing what's going to happen. The events change constantly. It's really quite dynamic."

Not long ago, compliance chiefs sat at the little kids' table during management meetings. They had good, almost informal, relationships with examiners, but were often shunned by business-line brethren, who saw them as obstacles to pursuing money-making strategies, and more or less ignored by the board.

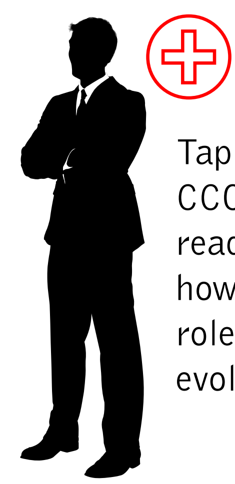
Today, they're the new rock stars of the management team. They typically have the power to initiate new policies, stick their noses wherever trouble might lurk, and even modify or veto products that don't pass muster.

Their relationships with examiners are no longer as cordial as they once were—a testament to the perceived seriousness of the issues and to the compliance chief's higher profile. It's not unusual to find them sitting on executive committees, getting direct access to both the CEO and the board and even voicing their opinions on strategy.

"I tell people it's the second-best job in the organization," says Paul Osborne, a partner and compliance specialist at Crowe Horwath LLP, an accounting and consulting firm, who is presently playing the role of temporary CCO for three small banks. "You get to know a lot about all the areas of the bank; you just don't get to play as much golf as the CEO."

The post-financial crisis world ushered in a tougher regulatory regime that includes not only traditional safety-and-soundness and Community Reinvestment Act (CRA) requirements, but also mandates—overseen by the Consumer Financial Protection Bureau (CFPB)—to ensure that customers are treated fairly. Post-9/11 Bank Secrecy Act (BSA) requirements to sniff out money-laundering schemes have added layers of reporting demands.

WHAT'S CHANGED?



Tap the CCO to read how the role has evolved.

> "BOARDS ARE RECOGNIZING THE IMPORTANCE OF GOOD COMPLIANCE.

TODAY, THEY'RE THE NEW ROCK STARS OF THE MANAGEMENT TEAM.

To keep their banks out of trouble, smart boards are making compliance a cultural imperative, deputizing compliance chiefs to build and maintain systems that make compliance everyone's job.

"Boards are recognizing the importance of good compliance," Osborne says. "Without it, mergers get stalled, customers get unhappy and reputations are damaged."

In his three years at Associated, for instance, Heise has introduced an array of new policies, procedures and guidelines aimed at reinforcing a new culture that makes compliance a collaborative venture.

Central to the effort is a colleague accountability policy, introduced two years ago, which makes compliance part of everyone's job description and performance reviews. His department also has worked with human resources to incorporate compliance into performance reviews.

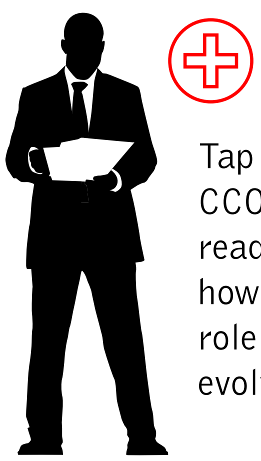
"It's gone a long way to building consciousness, awareness and sensitivity about regulatory compliance," Heise says. "We provide the guidelines, but the business lines are primarily responsible for compliance. I'm really just the central clearinghouse."

As the primary conduit between their institutions and the alphabet's soup of regulatory agencies that oversee various bank activities, they can find themselves walking a tight wire between the bank and examiners.

"I jokingly say that I get paid by the bank, but I work for the government," says Heise, who has a full-time OCC examiner stationed 20 feet from his office, and expects to endure three separate CFPB examinations this year—one each for mortgage originations, mortgage servicing and deposit accounts.

"It used to be that examiners came in, wrote their report and left," he says. "Today, it's continuous monitoring, and quite frankly, they're always right. We always have to do what they say."

WHAT'S CHANGED?



Tap the CCO to read how the role has evolved.

And if the bank doesn't follow the rules, the risk of personal liability for compliance officers is real. In December, FinCEN assessed a $1 million civil money penalty against Thomas Haider, the compliance chief officer for Moneygram International, for "willfully" violating a grab bag of BSA requirements. Experts expect to see more enforcement actions against the heads of compliance operations.

"All of this regulatory focus is making life very interesting for chief compliance officers," says Ralph Sharpe, head of the financial services compliance team at Venable LLP, a Washington, D.C. law firm. "They're getting more resources and staff, but also face a real possibility of becoming a potential target if something goes wrong."

To avoid trouble, chief compliance officers are expected to serve as modern-day regulatory soothsayers, peering into their crystal balls to identify coming risks. "It's the compliance head's job to sound an early alarm if things aren't going like they should," Sharpe says.

One emerging area that keeps Heise awake, for instance, is Associated's relationships with third-party vendors in areas like identity theft, debt-protection or mortgage insurance. Providers of those services get access to customer data, and must pass regulatory muster themselves or it can come back to bite the bank.

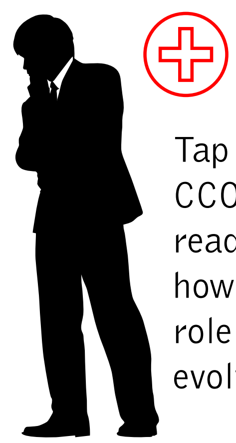
They also have to manage growing staffs. Smaller banks might have three or four specialists who focus on areas like lending or deposit operations and report to the senior vice president of operations. The largest banks employ thousands of compliance professionals reporting to either the general counsel or chief risk officer.

The constant is that everyone is spending more time and money on compliance. Osborne tells of running a five-person compliance department at a small bank 25 years ago. "Today," he says, "a similar compliance department would have more than 50 employees."

At Associated, Heise's 140-person team includes separate BSA and CRA officers, as well as individual compliance staffers embedded inside business lines who serve as Heise's eyes and ears, and work to help ensure that products and services meet standards.

With the numbers swelling, demand for good help is intense, and chief

WHAT'S CHANGED?



Tap the CCO to read how the role has evolved.

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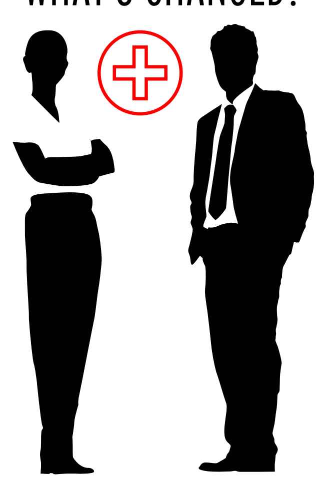

Tap the compliance officers to read how their role has evolved.

TO AVOID TROUBLE, CHIEF COMPLIANCE OFFICERS ARE EXPECTED TO SERVE AS MODERN-DAY REGULATORY SOOTHSAYERS.

compliance officers spend more time than they want recruiting workers—and keeping the ones they have. It's not uncommon for banks to pilfer compliance staff from each other, though it doesn't always work.

Sharpe tells of one bank client in south Texas that is on its third BSA officer in the past two years. "The bank is literally forced to go to recruit people from other parts of the country," he explains. "And they have to pay people some multiple of what anyone else at that level would get paid to get them to come."

Compliance specialists saw their total average pay jump 18.5 percent in 2014 to $59,081, according to Crowe Horwath. Heise was the director of enterprise risk services at U.S. Bancorp when he was hired as Associated's chief risk officer. He's since lost several employees from his 140-person staff to in-market rivals U.S. Bank and Wells Fargo & Co.

"Our people are being solicited constantly," Heise says. "Managing the turnover is one of my big challenges."

But it's far from the only one. **|BD|**

John Engen is a Minneapolis-based financial and business writer.

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IF YOU HAVEN'T LOOKED AT YOUR DIRECTORS AND OFFICERS POLICY IN YEARS, **IT MAY BE TIME.**

WHAT CAN GO WRONG WITH YOUR INSURANCE COVERAGE

BY **CHARLES KEENAN**

When it comes to liability insurance, all too often the vulnerability of directors and officers gets lost in the details, and that can lead to big personal losses.

In one scenario, featuring the failed Bank of Lincolnwood in Illinois, the Federal Deposit Insurance Corp. (FDIC) directly sued some of the former officers and directors, eventually settling with four of them at various dates in 2012 and 2013. The defendants were required to pay amounts ranging from $65,000 to $125,000, according to agreements posted on the FDIC's website. The bottom line is—when a policy comes up short—directors with any personal assets become fair game for plaintiffs.

"If there isn't an insurance policy and you have a significant net worth—guess what—you are the target," says Tom Vartanian, a partner at the law firm Dechert LLP in Washington, D.C. "Directors need to understand that once they go on the board, they have put that money on the table."

These days, even though the market for directors and officers liability (D&O) insurance for banks has softened, with ample number of carriers and declining rates, bank directors must be as diligent as ever with regard to making sure they are the least exposed as possible. There are always plenty of issues for directors to consider when renewing a policy or stepping on a bank board for the first time, details that might turn into nightmares many years from now.

Tap to view

TOP D&O INSURERS

Last year, 49 lawsuits related to management and professional liability at financial institutions were filed, down slightly from 51 a year earlier, according to Advisen, a research firm. The cases, mostly in federal court, included 20 merger objection lawsuits, the most common type of filing in 2014. In addition, there are ongoing D&O lawsuits stemming from FDIC actions against failed banks. The FDIC had filed 105 lawsuits naming 800 former directors and officers as of Feb. 25 this year, dating back to Jan. 1, 2009.

Meanwhile, cybersecurity breaches have emerged as a new threat, with a few lawsuits filed against directors over data breaches at their companies, most notably at Target Corp. and a few others. They have yet to fully manifest themselves in terms of liability case law. In the boardroom, the fear is there. Directors could be in the crosshairs of plaintiffs' lawyers, notes Scott Jenkins, a director for Bryn Mawr Bank Corp., a $2.1 billion asset financial institution based in Bryn Mawr, Pennsylvania. "Ubiquitous in every discussion today is cyber," he says. "It's like anything else. It spills over and ultimately it's the director's fault."

On the good side, the D&O market for financial institutions is as stable as it has ever been since the credit crisis. Premium renewal rates for financial institutions this year are down about 5 percent, according to Marsh, an insurance broker based in New York. For those banks that had rates hiked significantly post financial crisis, prices have come down much more than that. Large banks can generally purchase up to $1 billion on limits, notes Thomas Orrico, a managing director and head of the financial institutions practice at Marsh's financial and professional liability division. "There is much more competition to write D&O insurance for banks," he says. "There

“IF THERE ISN’T AN INSURANCE POLICY AND YOU HAVE A SIGNIFICANT NET WORTH— GUESS WHAT— YOU ARE THE TARGET.”

—**TOM VARTANIAN,** PARTNER AT THE LAW FIRM DECHERT LLP

THE THREE SIDES TO D&O

SIDE A. This coverage kicks in when a company cannot or will not indemnify the board member. It covers the personal assets of directors, officers and employees. There’s generally no retention, or deductible, since the goal is to protect the net worth of the individuals.

SIDE B. This covers directors, officers and employees if the company is able to indemnify them. A retention applies to this type of coverage.

SIDE C. This covers the corporation, and is generally used for insurance claims. The retention is typically bundled with Side B.

is also general willingness to ensure and enhance coverage."

That said, boards need to dig into the policies written for them, while leaning on brokers as a key source to guide them, notes Kristin Roger, chief underwriting officer for Travelers Cos., an insurer based in Hartford, Connecticut. "The board needs to be very aware of their risk and that they are actively trying to manage that risk. These are not easy policies to understand; they are not off the rack."

Given all the risks a bank faces, here are a few things to consider to better shield directors and officers from unforeseeable events:

Limits

Make sure the limits of liability are adequate. Policies often are renewed without much attention to detail, Vartanian notes. "If there is insurance, it's basically a negotiation about how much, if not all, of the insurance proceeds the FDIC can get," he says. A limit such as $5 million could cover legal fees for as little as six months, depending on the case. "Some people haven't rethought the limits of liability in 25 years on their policies," he adds. "The question is, 'Where are you, and how much coverage do you have?'"

Also, make sure the limits stand alone, adds Kevin LaCroix, an attorney and executive vice president at RT ProExec, a division of Chicago-based insurance brokerage R-T Specialty. "If the limits are shared with other lines of insurance, there may not be enough in one of those bad situations where there are multiple, simultaneous claims," LaCroix says.

To help determine amounts, brokers can help. Some have been supplying more modeling, using analytics and peer benchmark data, looking for correlations to lawsuits and variables such as market capitalization and debt to help predict the probability of a lawsuit over the next 12 months, giving clients a loss distribution to help set limits. This helps directors see what a loss would look like and the average settlement given the characteristics of their bank, Orrico says.

Regulatory Exclusions

In the current environment, even banks operating under a consent order can get regulatory coverage. An exclusion, however, can do a lot of damage, LaCroix notes. "That's a very harsh term to put on a policy," he says. "Often the type of claim [excluded] would be something brought by a regulator." Directors also need to pay attention to the definition of what a claim is, Orrico adds. If it's not broad enough, then the insurance might not pay for legal expenses relating to regulatory investigations.

Pending and Prior Litigation

Insurers will also try to exclude events arising from past litigation. Try to make sure the agreement will include D&O lawsuits from these events. "Some exclusions can be very broad and knock out everything," Orrico says. "You have to be very careful."

Run-Off Policies for Sellers

Typically an acquiring institution will want to fold a target bank's board into its own policy, under the impression it will save money, notes Roger. But many policies will include an insured versus insured exclusion, which precludes claims of one insured against another. That might end up a nightmare for the board of the seller if the acquiring bank decides to later sue them. "Once you add another board to your policy, you are now insured," Roger says. "Now they are all stuck, because the insurance isn't going to respond in the event the acquiring company sues the board of the old company." To remain covered, boards of the seller should insist that there is a separate run-off policy that covers them for future events, Roger advises.

Meetings With the Underwriter

Face-to-face meetings with an insurer before renewing or buying a policy can help lower premiums, Orrico notes. "You need to be as transparent as possible, meeting your insurer to tell them the bank's story, and differentiate its D&O risk profile. That will ultimately benefit the bank when securing insurance," he says.

In all, with D&O insurance, make sure the details are covered. "The board [members] need to be very aware of the risk and that they are actively trying to manage that risk, and that they are not just sticking their head in the sand," Roger says. **|BD|**

Charles Keenan is a freelance writer in Los Angeles.

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McLagan's *New* Market Practice Studies

For Regional & Community Banks and Credit Unions

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- Relationship Manager model vs. Business Development/Portfolio Manager model
- Priorities in evaluating performance

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- Turnover
- Non-compete/non-solicit agreements
- Sign-on bonuses

Compensation

- Incentive plan types
- Risk adjustments or performance objectives
- Plan caps
- Long-Term Incentive prevalence
- Compensation Trends

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This study focuses on retail banking pay practices, organizational structures, and staffing trends. Sample topics include:

Incentive Plans

Position groups: Branch Management; Personal Bankers; Universal Bankers; Tellers; Customer Service

- Plan type
- Performance measures used
- Target incentive amounts
- Contemplated future incentive plan changes

Branch Trends

Hot Jobs – Compensation differences compared to traditional roles, position prevalence

- Universal bankers

Staffing & technology trends

- Headcount/Turnover
- Technology used
- New branch technology implementation

Regulatory Provisions

- Sales staff FLSA exemption status

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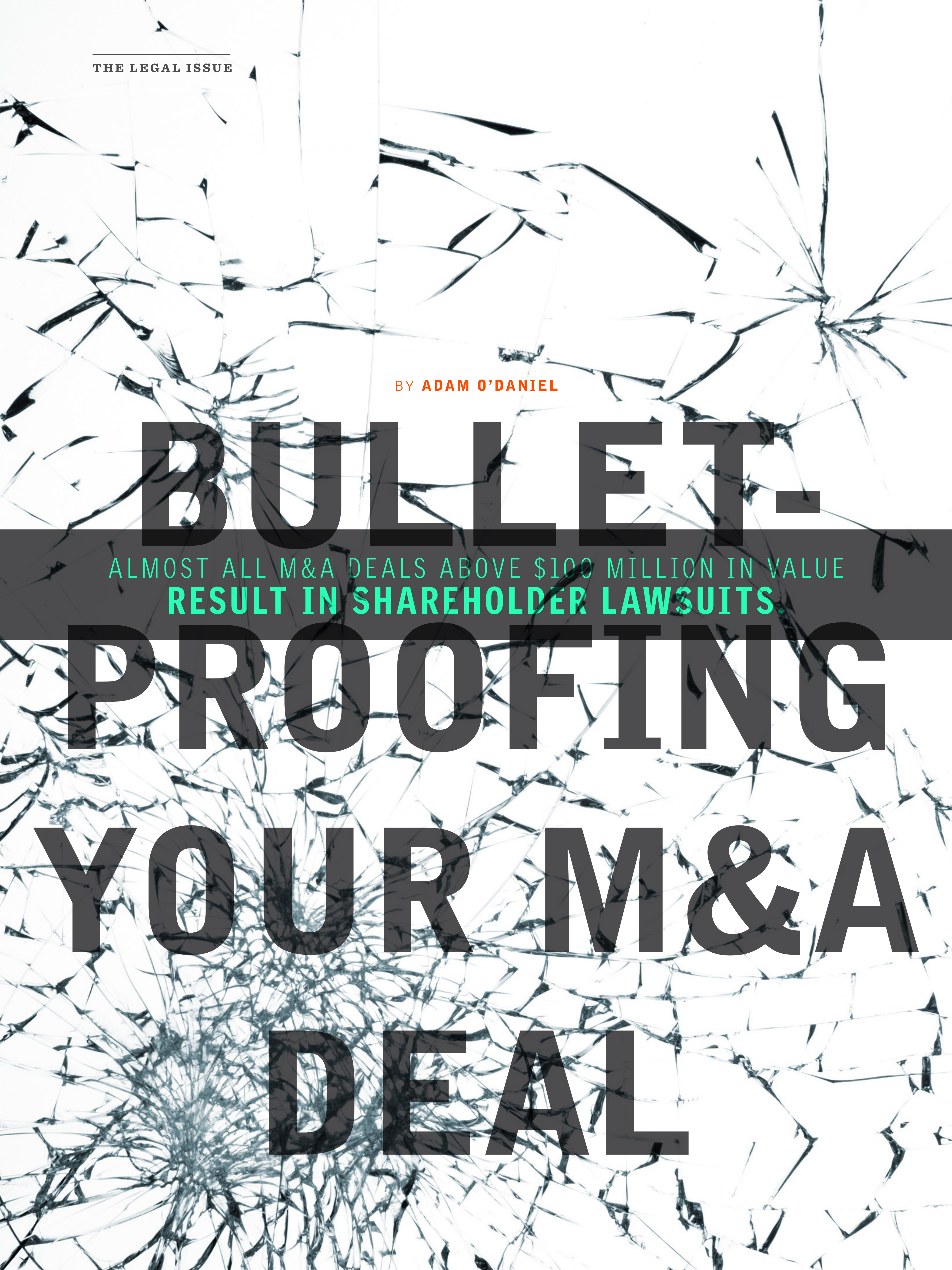

BY **ADAM O'DANIEL**

BULLET-PROOFING YOUR M&A DEAL

ALMOST ALL M&A DEALS ABOVE $100 MILLION IN VALUE **RESULT IN SHAREHOLDER LAWSUITS.**

Attorney Bill Pitman once spent more than 10 hours sitting in a Courtyard by Marriott meeting room doing nothing but answering questions from members of a bank's board of directors. The goal? To protect the board if a lawsuit followed its planned merger-of-equals. He wanted to make sure every member of the board asked, documented and received an expert opinion on any possible question or concern.

"I remember sitting in a chair in the middle, facing a U-shaped table, just answering questions, nothing else, all day," says Pitman, an ex-corporate banker and now a securities lawyer in Greenville, South Carolina, with Smith Moore Leatherwood PLLC. "When I work a deal, I make sure the board has an outside opinion on everything."

That bank successfully avoided legal roadblocks related to its merger. Others haven't been so lucky. As bank mergers and acquisitions (M&A) activity has increased, so has the number of shareholder lawsuits. In 2014, 289 whole bank M&A transactions were announced in the U.S., a 28 percent increase from 226 such deals in 2013, according to data compiled by SNL Financial.

Legal challenges to M&A transactions are nearly guaranteed following the announcement of a deal. Mergers of equals are especially susceptible. All-cash transactions have less risk, but there still is the possibility of a lawsuit. Cornerstone Research, a Menlo Park, California-based firm, reports that for five consecutive years, more than 90 percent of all corporate M&A deals valued over $100 million have resulted in a class-action shareholder lawsuit. "The few companies that do not get sued are often small community banks," Cornerstone Principal Olga Koumrian says. "But it's only slightly fewer."

These lawsuits are often trolling for a settlement that pays attorneys legal fees and little else. But even nuisance lawsuits are costly as banks pay legal fees, make additional disclosures or take other steps to resolve the challenge. Directors and officers who prepare far in advance gain a significant advantage if they choose to fight the lawsuit.

Is there any way to make a deal lawsuit-proof? "That's like asking how tall is a mountain," says Roanoke, Virginia-based attorney Hugh Wellons, co-chair of the community banking group at Spilman Thomas & Battle PLLC.

— **BILL PITMAN,** ATTORNEY WITH SMITH MOORE LEATHERWOOD PLLC

IMPATIENCE IS THE BIGGEST SIN. YOU CAN GET DEAL FEVER.

"It's a simple question. But it's a very nuanced answer."

Legal experts generally agree boards of directors can't make a deal suit-proof. "There's nothing you can do to prevent it, but the advanced preparation does count," says Eric Luse, partner at Washington, D.C.-based Luse Gorman, PC, where he has worked on a number of high-profile M&A transactions in banking and finance. But bank boards can reduce their exposure to legal trouble following M&A announcements by following several best practices months and even years ahead of time.

DO YOUR HOMEWORK

Just like the three keys to real estate, bank M&A often boils down to three things: "Due diligence, due diligence, due diligence," Wellons says. "A bank that prepares its financials conservatively, discloses good and bad developments as soon as it is sure of them, runs its lending practices with discipline and rewards management fairly, but not lavishly, should do fine."

Pitman says he advises his banking clients to hold board planning retreats with legal counsel and investment bankers to set and document a strategy several years into the future. He says that step shows the board's action to pursue M&A is part of a long-term plan. He encourages directors to ask the "stupid questions" and document the answers to show their diligence. It's important for boards to have a paper trail that shows they have given proper consideration from the very beginning to compensation agreements, breakup fees, pricing, conflicts and other common issues.

"Not only must you do a good job and be well-informed as a director, but it needs to look like you've been doing a good job and staying well-informed," Pitman says. "Impatience is the biggest sin. You can get deal fever." Luse says almost every objection to a deal can be defended if a board can prove its diligence. "Ask questions. Don't take anything for granted," he says. "Don't rush through the process."

KEEP SHAREHOLDERS PREEMINENT

Larry Carroll has been involved in selling and buying banks as a director in Charlotte, North Carolina, for the past 20 years. He's currently on the board at $2.5 billion asset Park Sterling Corp., which is based in Charlotte. He says one of the challenges of M&A negotiations is balancing multiple interests. "You ask yourself if this is good for the shareholders, but you also are thinking about the employees and management and where the headquarters might be. It's complicated," he says. "You will get attacked on the idea that you didn't maximize value. The board needs to know that and build a defense as you go."

Carroll's Park Sterling in 2012 bought Citizens South Banking Corp. in Gastonia, North Carolina, and faced a shareholder lawsuit that ended in a settlement requiring Citizens South to disclose additional details about the M&A negotiations and how the deal favored stockholders. "With community banks, the directors cannot help but think of the employees, people they live and work with," Wellons says. "It is a tough balance, because their first duty is to the shareholders." Luse says directors need to show themselves responsible and patient as shareholders, too. Large positions or sales will be scrutinized after a transaction is announced. "Directors should be long-term," he says. "Don't be an active player in the stock."

RELY ON GOOD ADVISERS

Banks will be attacked in court filings for everything from conflicts of interest to sale price and negotiation tactics. But directors will have a better defense when they point to evidence that they relied on the advice of third-party professionals, Luse says. "You must have experienced advisers, both legal and financial, every single step of the way," he says.

Pitman says one M&A deal he worked on featured a bank with several directors that held huge stock positions or employment ties to the bank. So the board carved out a special committee of directors without conflict and hired additional investment bankers and legal experts to advise the special committee. "You need to hire advisers who will tell you, 'no,'" Pitman says. "A small community bank doesn't need to go to Wall Street. But they've got to have recognized and credible advice."

Of course, lawsuits are likely even for the most prudent bank transactions, making defensible practices of utmost importance, and victory for directors worth watching. New Jersey's ConnectOne Bancorp and Center Bancorp orchestrated a $243 million merger in early 2014 to create a combined lender with $3 billion in assets. Shareholder plaintiffs filed at least three class action lawsuits, arguing Center (the legal acquirer) wasn't paying enough for ConnectOne. But the legal complaints, in a rare occurrence, were voluntarily withdrawn after the bank decided to fight. The two banks and their boards had bullet-proofed the transaction.

"We were lucky, or we were brilliant," quips attorney Peter Bray of Bray & Bray PLLC, who represented Center Bancorp. "A lot of these complaints don't have much substance. Sometimes the plaintiff would rather surrender." **|BD|**

Adam O'Daniel is the finance editor of the Charlotte Business Journal.

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BANKS DECIDE TO FIGHT LAWSUIT

ConnectOne Bancorp's Chairman and CEO Frank Sorrentino discusses the bank's decision to fight a shareholder lawsuit, and how it paid off.

A BOARDROOM CONVERSATION

Bank CEO Says It's Time to Change Regulations, Not Malign the Regulators

John Hairston is president and CEO of Gulfport, Mississippi-based Hancock Holding Company.

Stress testing has been an enormous cost burden, but some aspects of new regulations have improved risk management and internal controls processes, says John Hairston, president and CEO of Hancock Holding Co., a nearly $21 billion asset banking company based in Gulfport, Mississippi. Hairston also serves as vice chairman of the American Bankers Association's American Bankers Council, which drives the organization's policy and advocacy efforts for midsized banks. He answered *Bank Director* magazine's questions recently about his approach to regulation and regulators.

What is your philosophy about how to handle the relationship with your bank's regulators?

In general, we practice professional respect between regulators and our team. Regulators get a peek inside the best-run and worst-run organizations in the U.S., so they have a great knowledge resource from which to draw constructive concepts. We haven't enjoyed every regulatory interpretation since Dodd-Frank was passed; but the vast majority of all the work we've done—some of which was directly suggested by regulators—has led to better risk management and internal controls practices.

Dodd-Frank added a great deal of burden not only to banks, but also to regulators. Regulators are sometimes maligned for simply doing what they are compelled to do, given the language in hastily enacted legislation. The right path forward is to spend less time hand-wringing and more time constructively working with regulators and Congress to remediate language that caused unintended and harmful

SWIPE UP

A BOARDROOM CONVERSATION

Bank CEO Says It's Time to Change Regulations, Not Malign the Regulators

Congress to remediate language that caused unintended and harmful consequences. Working trumps whining every time.

John Hairston is president and CEO of Gulfport, Mississippi-based Hancock Holding Company.

What has changed about the regulatory or compliance structure at your bank in the last few years?

We are certainly more proactive. The stakes are higher, and regulatory failures have higher consequences. We have more lawyers to interpret regulation faster, and the corporate risk organization is many multiples larger than before Dodd-Frank.

How many employees have you added to your compliance framework in the last five years?

It's difficult to put a number on the additional employees added to comply with Dodd-Frank. Every job in the bank touches an element of regulatory compliance. The increased burden means increased hours spent by bankers on regulatory disclosure and file documentation required for regulatory examinations. Additional staff is necessary either to help relieve that burden or assist bankers in doing other aspects of their jobs. We've also built up our audit department and built out an enterprise risk management (ERM) department. Our outside counsel and consultant budgets have increased as well.

As the CEO, what percentage of your time, on average, do you spend on regulatory or compliance issues?

From 2011-2013, close to half of my time was focused on regula-

SWIPE UP

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From 2011-2013, close to half of my time was focused on regulatory, compliance or related items. That number has dropped to about 10 percent, depending on the time of the year. I believe banks and regulators are all finding their cadence in the new environment. We are all headed to a better place.

What have been some of the biggest impacts on your bank of all the regulatory changes in the last few years?

Stress testing, and especially model validation, added a huge cost burden. Now, that said, there is great value in stress testing with regard to capital and risk planning. But, midsized banks that do not pose a systemic threat should be running stress scenarios applicable to the specific risks in our markets and balance sheets versus the prescriptive tests provided by regulatory agencies.

SWIPE UP

WHAT IS MOST LIKELY TO KEEP YOU UP AT NIGHT WORRYING?

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