

Client Alert

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Financial Institution Directors' Duties: Key Considerations and Lessons from the 2008 Financial Crisis

In responding to the novel coronavirus (COVID-19) pandemic and operating under the various emergency orders that have been issued by federal and state governments and other regulators, financial institutions and their boards of directors will have to make significant decisions in “real time” based on imperfect information and rapidly changing circumstances. Under the common law “business judgment rule,” courts generally defer to decisions made by a majority of independent and disinterested directors, including decisions made during a crisis. In addition, directors are usually entitled under state law to rely in good faith on corporate records and information and on the advice of officers, employees, and outside advisors. Nevertheless, there are important lessons learned from the 2008 financial crisis that are pertinent now.

For example, in one case that emerged in the aftermath of the 2008 financial crisis, a federal bankruptcy court refused to dismiss a complaint brought by a bankruptcy trustee against the former directors and officers of a publicly traded corporation which, because of major liquidity issues at a subsidiary, had become insolvent during the financial crisis. In denying the defendants' motion to dismiss, the bankruptcy court held that the plaintiff's complaint sufficiently stated a claim that the directors and officers had engaged in “willful misconduct” by consciously failing to take action in response to the corporation's known liquidity problem. Among other things, the plaintiff alleged that the board of directors failed to investigate the corporation's problems, met infrequently, and failed to engage in any substantive discussions about the situation until the corporation's bankruptcy was nearly certain. The plaintiff also alleged that the board of directors of the corporation's operating subsidiary did not have formal meetings as the crisis unfolded. While we believe there are significant issues and limitations regarding the case, we also believe it highlights some general principles that we encourage directors to follow now more than ever.

To protect directors who make a good faith attempt to manage a corporation in accordance with their fiduciary duties, the business judgment rule provides a judicial “presumption” that a board's actions were taken on an informed basis, in good faith and in the honest belief that the actions taken were in the best interest of the corporation. In other words, the business judgment rule protects directors from liability for making honest and reasonable judgments regarding company operations that turn out, in hindsight, to be unwise. Unless a plaintiff can rebut the business judgment rule by showing the board breached its fiduciary duties, a court ordinarily will give great deference to the substance of the directors' decision, will not invalidate the decision, will not examine its reasonableness, and will not substitute its views for those of the board.

Even in the wake of the 2008 financial crisis, the Delaware courts dismissed numerous stockholder lawsuits claiming that the boards of directors of various financial institutions breached their duties by making flawed decisions or by failing to oversee and monitor their corporations. Nevertheless, there is risk that after a crisis, the board's actions will be questioned, especially if the financial institution is rendered insolvent. For that reason, it is important for boards of directors to follow a process that helps demonstrate that they made decisions with care and in good faith.

It is well established under prior Delaware court decisions that a board's decisionmaking process must be an informed one. A director must discharge his or her duties as a director “with the care an ordinarily

prudent person in a like position would exercise under similar circumstances.” That is, before making a decision, directors must inform themselves of all material information *reasonably* available and relevant to the decision. Directors must act with the utmost care in informing themselves of the relevant and available facts before taking any action on behalf of the financial institution. However, in times of crisis, there will be uncertainty and directors may be asked to act with less than perfect information. Directors need to do the best they reasonably can, given the circumstances, to make decisions based on the material and relevant information that is reasonably available.

In reviewing a board’s decisionmaking process, courts and regulators can be expected to inquire into the number of meetings held, the types of written materials provided to the directors, and whether the directors received advice and reports from officers, employees, and outside advisors. It has long been clear that, from a litigation and regulatory standpoint, creating an evidentiary record of a board’s process will best position that board to defend itself in future litigation or challenges from the financial institution’s regulators. This is particularly important today, as the decisions made by a board of directors during a crisis may later be second-guessed by regulators, courts, shareholders, the media, and others.

Thus, a clear lesson from the 2008 financial crisis is that financial institutions can help protect directors and officers by focusing on the following aspects of board process in these challenging times:

- The boards of directors of financial institutions should continue actively to oversee and monitor the entity, including the financial institution’s response to COVID-19. To do so, many boards will need to convene more frequently through telephonic special meetings to receive updates from management. It may also be appropriate for management to send periodic written briefings to directors between board meetings, but such briefings should not substitute for meetings.
- Directors should understand the key risks facing the financial institution from COVID-19 and management’s strategy for avoiding or minimizing those risks. Management’s strategy should deal with short-term and long-term crisis scenarios. While each financial institution’s situation is unique, potential topics include:
 - evaluating the crisis’s effects on the financial institution’s operations and financial condition, liquidity, regulatory capital, ability to service debt, and compliance with debt instruments;
 - evaluating the crisis’s effects on customers, and evaluating the financial institution’s reserves for potential loan losses;
 - compliance with various government emergency aid programs in which the financial institution is participating;
 - minimizing health risks for officers, [employees](#), and other stakeholders;
 - reviewing management’s strategies under a variety of COVID-19-related scenarios, including extended government closures;
 - reviewing emergency succession plans in case key executives become ill;
 - evaluating the financial institution’s rights to [recover business losses](#) under insurance policies; and
 - considering whether potential business opportunities have been created.
- In monitoring the financial institution, some boards may delegate certain functions to existing committees. Some boards may also decide to form a special committee to oversee the financial institution’s handling of the COVID-19 crisis between board meetings. These special committees should be carefully selected with members who have appropriate experience and expertise to address the special challenges that the COVID-19 pandemic presents and who also have the necessary time to oversee management on a more frequent basis.

- In conducting meetings, boards and committees should try, to the extent practicable under the circumstances, to adhere to regular formalities regarding notices, waivers of notice, agendas, pre-meeting board packets, and executive sessions.
- It remains important for management to do its best under the circumstances to provide directors with timely and accurate information, even though that may be impossible in some situations.
- Board and committee meetings should be documented through appropriate minutes that help build an evidentiary record that the directors were discharging their duties.
- Utilize outside experts and advisors to advise the board where appropriate.
- Exercise caution in declaring dividends or other distributions or authorizing stock repurchases that are subject to statutory insolvency tests.
- Be mindful that, while board decisions approving executive compensation matters, dividends, or stock repurchases may be protected under the business judgment rule, such actions may reduce liquidity and may also subject corporations to statutory insolvency tests. These actions may also conflict with ever-evolving federal and state banking regulations and guidance, and financial institutions should be aware that some regulators are particularly focused on stock repurchases in the current environment. Such actions may also have consequences in the financial institution's ability to seek government assistance. There is also reputational risk arising from these actions in the current environment.
- Exercise a high degree of caution before dealing in the financial institution's securities, given the increased risk that an insider will be deemed to have possessed material non-public information. This also applies to "affiliates" of directors and officers (such as family members under their control or living in their homes), who are assumed for insider trading purposes to have access to the same material non-public information as the director or officer. Indeed, the Securities and Exchange Commission has advised recently of its concern about the risk of unlawful trading in this turbulent market.

While there are many similarities today to the financial crisis in 2008, there are also differences that should be top-of-mind for every director. Unlike in 2008, there are more advocates pushing for a revised definition of "corporate purpose," where boards are answerable not only to shareholders but *also* to the corporation's employees, customers, communities, and other stakeholders. Especially in the current environment, there is a growing sensitivity throughout the country to financial institutions doing what is 'right' for their employees and customers.

Each financial institution's situation is contextual and also depends on applicable law, and we are available to our clients for assistance. In addition, our firm's COVID-19 resource center is available [here](#).

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