SPEECH OF ASSOCIATE GENERAL COUNSEL NORRIS C. BAKKE BEFORE SUPERVISING EXAMINERS CONFERENCE, APRIL 27, 1950, Washington, DC.

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LEGAL RESPONSIBILITY OF BANK DIRECTORS

In his brief introductory remarks to you on Monday, Mr. Sailor said among other things that new problems are continually arising. The statement is axiomatic to life in general, and the fact is what gives basis for the legal profession. Much as most of you might wish there seems to be no escape from legal problems in your work although I hope we can help keep them at a minimum for you.

The particular problem we want to consider briefly this morning is the legal responsibility of directors. I think I need not tell you how close the business of bank examination lies to this responsibility of directors. For example, Mr. Sailor said in his speech to the Eastern Regional Conference meeting in this city just a year ago -"Any examination which discloses matters of significant criticism, or of importance otherwise is ordinarily concluded with a conference between the examiner and the directors, in order that the matters requiring the special attention of the latter may be fully reviewed to insure their understanding and to determine proposed correction." With the development and growth of banking legislation in this country, particularly since the turn of the century, broader powers have been prescribed for the chartering authority to make periodic visitations or inspections to determine that the bank was not exceeding its statutory powers.

Generally it may be said that the bank directors' legal responsibility is of two kinds, viz: statutory liability, è.e. for noncompliance with the laws of the state for failure to perform the duties imposed on them by law, and second, common law duty under decisions of our courts holding the directors responsible for losses suffered by depositors and others because of negligence or carelessness in discharge of duties not specifically provided for by statute.

In this development of bank legislation which I mentioned a moment ago, the part played by you men and the examiners working under you has been and continues to be important, because it is through your suggestions and recommendations that new duties devolve upon directors, and when these new duties are sufficiently definite and extensive they frequently crystalize into statute law, and there may be times when successive failures to carry out your suggestions are the proximate cause of a loss, that financial liability will attach to the directors, and this liability may attach without warning from the examiner, if the director fails to do what an ordinary prudent man would do under the circumstances.

As Mr. Oppegard indicated to you on Monday, there are at least 58 practices that have been designated by the Corporation as unsafe and unsound. From a review of the litigated cases, as Mr. Oppegard also indicated to you, it appears that there has been a stamp of disapproval by the courts on a large number of these practices and as to those, it is reasonable to suppose that in the event that insurance was terminated that directors liability would attach if it were shown that a subsequent failure of the bank were caused by the unsafe practice indulged in.

Conversely, it would not necessarily follow that directors would be liable if the bank were forced to close, because of shrinkage of deposits caused by the termination of insurance. A couple of years ago it looked like we might have a legal test of this question when the Corporation was sued for cancelling the insurance of a bank in Tennessee, but the President got cold feet and abandoned his case.

~~That~~ Bank directors ~~may~~ are not necessarily ~~be~~ liable even though our Board finds that the bank has been guilty of unsafe and unsound practices. ~~appears for two reasons.~~ ~~(1)~~ Assuming it is ~~not~~ obligatory on our Board to terminate insurance ~~even though~~ after a finding has been made that the practice was unsafe, and ~~(2) even if~~ insurance is terminated, the finding of the board is not conclusive unless supported by substantial evidence, a question which the courts will in a great majority of cases always entertain.

The point I have been trying to make here is well illustrated by two leading cases on this subject, both of which are quoted from in E. B. Strouds' memorandum in your examiners' book of instructions. In the Thomas v. Taylor case, 224 U.S. 73, the Court held the directors were liable because they failed to heed the direction of the examiners who had told them that the doubtful assets of the bank were over twice the capital, while in Anderson v. Akers, 7 Fed. Supp. 924, where the examiners condoned certain ultra vires acts of the directors, the Court held that that could not "affect the liability of such directors for permitting what they must be deemed to have known was unlawful".

This point illustrates too, the problem that you men and our Board are up against when you and it are called upon to pass on the factor of bank management. In view of the standards that have been developed over the years, the problem is not too difficult but I am sure we all realize that there are areas where an attempt on the part of the examiner to tell the directors how to run their bank gets outside of your sphere of operations. In other words, the law places the responsibility of running the bank on the directors, and as long as they violate no law, nor engage in unsafe and unsound practices, you men and your examiners should be as circumspect as possible in your recommendations on managment if the words "free enterprise" are to have any meaning at all.

No doubt you men are all aware of the law that has recently been passed in New York referred to as the "Prudent Man" rule, in connection with investment of Trust funds, which is indicative of the trend to liberalize investments of such funds. You men are also aware that the legal relationship between the depositor and the bank is that of a debtor and a creditor, but that the relationship between a depositor and/or a stockholder may be that of a trust [redacted] and a number of court cases have so held. Strictly speaking, it is not a trust ~~such a relationship~~ because of the lack of identity of the res, i.e. there is no segregation of the money turned over to the bank, [redacted] nevertheless, the courts held that the special care required of bank directors was comparable to that of the trustee and numerous cases used the technical trust terms in describing the directors' legal responsibility. See Williams v. McKay, 40 N. J. Eq. 189. As I study the trend of current decisions, I think the courts are becoming more liberal in their analysis of the directors' responsibility and saying that they are not guarantors of the banks' funds but are charged only under the "prudent man" rule.

This leads us to a further consideration of the question which Mr. Oppegard touched on ~~the other day~~, and which was raised pretty directly by the Assistant Attorney General of Iowa the other day when he spoke to the Independent Bankers Meeting in Des Moines. There is no denying that there is a growing resentment against "assumed power" so-called by the bank supervising agencies, and to the extent, of course, that these agencies are usurping the functions of bank management (I do not concede that they are), the resentment is justified. Out in Iowa this cry was raised in defense of States rights.

The problem, however, is not as simple as that, and I think it is very fundamental. I can illustrate the point I am trying to make here by referring to my friend Richard Trefz of the Beatrice State Bank in Nebraska. To some bankers, and I think to some of our own people, he is not a sound banker ~~[illegible]~~. but to others and apparently to a large and powerful segament in our banking fraternity, he is in fact a servant of brotherhood. I have been told that some of his loans have been criticized because they are not properly secured. He answers by saying he knows his customers and that they will pay. Who is right? Only time can tell. The examiner justifies his criticism on the ground that the loans must be tested according to proven banking standards, while Trefz justifies the loans on business conditions as they are today. There seems to be a definite expansion of loans in the consumer lending field which means an increasing volume of character loans. You may have seen the recent story of the Louisiana bankerswho has been doing a large business on single signature, noncollateral notes with a loss ratio that was negligible. If these loans are within the statutory limits who can say with any certainty that they are good or bad. I do not envy you men in the responsibility that you have in this connection, because I understand how difficult it is to maintain standards that must be geared to as Col. Sailor describes them, constantly changing conditions, and it is in this field of supervision that your recommendations to the directors are very important. You can and must in many cases say to the directors as Abie in "Abie's Irish Rose" used to say "I am warning you" because as I have already indicated, with the warning a duty arises which if ignored may well give rise to directors liability.

Again, on the other hand, ~~tast~~ tacit approval, or failure to warn by your examiners, does not excuse the director if there has been an actual violation of the law. This occurred in the case of FDIC v. Mapp's Ex'r. et al, 37 S.E. (2d) 23, which arose in connection with the failure of the Parksley National Bank in Parksley, Virginia where the bank made an excessive loan to a Realty company,which had been formed by men interested in the success of the bank, to hold some real estate owned by the bank. The deal at the time it was made seemed perfectly sound because the value of the real estate was more than enough to cover the entire indebtedness of the Realty company but when those and other values fell sharpley and the bank failed it was discovered that the last $8,450 loan to the Realty company was in violation of the statute, and in the suit instituted by this Corporation we were allowed to recover.

There was an interesting side light on that case. After the verdict was in and accepted by the court and the jury discharged, and a motion for a new trial overruled, there was found among the papers in the case a yellow sheet of paper on which was written the following -"Inasmuch as the bank examiners and the FDIC examiners did not recognize the $8,450 loan to be illegal, by not warning the bank nor requesting immediate liquidation, nor taking legal action; the jury believe the transaction was legal and the bank incurred no damage". The discovery of this was urged as one of the reasons for a new trial, but, ~~of course~~, the court disregarded it. ~~but~~ Yet it is interesting as showing the reasoning ~~of the mind~~ of at least one juror who was supposed to have written it. Some of you who may remember the case may recall whether our examiner got a demerit ~~mark~~ on that one. It is also interesting to note that this case is authority for the statement -"It would be unjust and inequitable to permit the receiver to retain all benefits derived from the transaction and place all losses on the directors" and "Whatever of value the bank recovered from the borrowers on account of the (excessive) loan would go in diminution of damages". If this principle should be applied to all of our cases in liquidation, it is questionable if the FDIC could maintain an action for directors' liability if it has been made whole.

I am sure that all of you remember the stock argument that was used against the insurance of bank deposits; viz., that it would result in careless banking. Such has not been our experience, due no doubt to improved bank supervision. Nevertheless, I am persuaded that there has been a lessening of the urge to blame bank officials for circumstances resulting in our having to give relief to a distressed bank. Certainly it has been my experience since being with the Corporation that there has been sympathy rather than blame for the defaulter. This will not make it any easier for us to maintain directors' liability cases. Even in the very bad situation at Pryor, Oklahoma, where the loss was over a half million dollars there was a lot of sympathy for the thief. We have started a directors' liability suit there and it will be very interesting to watch developments.

As you are all aware nearly all of the purchase of assets cases which we have had in the last few years have been due to defalcations, and in those cases it is difficult to make out a case of directors' liability, because in most cases, the defaulter has to work very secretly, and in a number of our cases, it was quite by accident that the shortage was discovered. As Chairman Harl says, quoting familiar baseball language- "You can't hit 'em, if you can't see them", indicating that no blame can attach to your examiners or the directors either where there seems to be no sure way of discovering the irregularities.

Reverting a moment to the "assumption of power" which I mentioned a moment ago, and to Mr. Oppegard's comments Monday on banking business being conducted in the public interest, for a number of years following the turn of the century there was a very definite legal concept embraced in the phrase "affected with the public interest." Such industries and businesses as railroads, public utilities, express companies, etc., which had a large and direct contact with the public were so described, and this carried out the enlarged conception of the police power of the State to the effect that greater control would be exercised over such industries and businesses than over the ordinary private enterprises. The banking business was among those so considered thereby charging the bank officials with a higher degree of care and responsibility toward the public than was attendant upon other businesses. This, you can readily understand, is consistent with the idea of trusteeship which I discussed a few minutes ago. However, in the NEBBIA case in New York, 291 U.S. 502; frequently referred to as the New York Mills case, the Supreme Court abandoned the theory of "affected with the public interest", or according to the statement of Judge Black in the Union Shop LABOR Case, announced January 3, 1949, the theory was ditched. The effect of this may be to reduce the high degree of care which was required of bank directors while the doctrine was in effect. It will be interesting to watch whether or not the courts will follow this line of reasoning in bank directors' cases.

Those of us who heard Professor Rogers yesterday will remember that he quoted J. L. Robertson, Deputy Comptroller of the Currency, as having said, "Riskless banking is no banking at all." This is rather a significant statement coming from one in such a high place of authority in the banking business in the United States, but is thoroughly consistent with the thinking of this Corporation as it has been successively announced by its officers. There can be no question but that the Federal Deposit Insurance Corporation is committed to our dual system of banking as a free enterprise system and certainly we must agree that that contemplates the taking of normal risks by banking officials. So long as our Law contemplates this economic theory my notion is that the courts will attempt to give reasonable leeway to bank directors in the management and operation of their banks. This does not mean, however, that the courts will relax in their punishment of directors who violate the law because we are all aware of the fact that where prospective law steps in discretion is taken away.

Time will not permit my comment on E. B. Stroud's memorandum which I mentioned earlier in these remarks, but I hope that as your time permits you will reread and restudy this memorandum, which is a part of your book of instructions. I also wish to incorporate as a part of this address the screed entitled "Responsibilities of a Bank Director" written a few years ago by A. J. Veigel, a former Commissioner of Banks of the State of Minnesota, which was furnished us by our friend, Mr. R. A. Amundson, another former Commissioner of Banks of Minnesota.

I also want to express my personal appreciation to Mr. Anderson of the Comptroller of the Currency's Office, for making available to all of us the Comptroller's study on the "Duties and Liabilities of Directors of National Banks", Form 1417, Treasury Department, Office Comptroller of the Currency. This is a most excellent statement and I hope that each of you will take time to study it carefully.

In conclusion, I think the duties of bank directors have been very well summarized in a recent New York case, which I am taking the liberty of quoting:

"(1) Directors are charged with the duty of reasonable supervision over the affairs of the bank. It is their duty to use ordinary diligence in ascertaining the condition of its business, and to exercise reasonable control and supervision over its affairs. (2) They are not insurers or guarantors of the fidelity and proper conduct of the executive officers of the bank, and they are not responsible for losses resulting from their wrongful acts, or omissions, provided they have exercised ordinary care in the discharge of their own duties as directors. (3) Ordinary care, in this matter as in other departments of the law, means that degree of care which ordinarily prudent and diligent men would exercise under similar circumstances. (4) The degree of care required further depends upon the subject to which it is to be applied, and each case must be determined in view of all the circumstances. (5) If nothing has come to the knowledge to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, upon the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required, and a want of that care makes them responsible. Directors cannot, in justice to those who deal with the bank, shut their eyes to what is going on around them. (6) Directors are not expected to watch the routine of every day's business, but they ought to have a general knowledge of the manner in which the bank's business is conducted, and upon what security its larger lines of credit are given, and generally to know of and give direction to the important and general affairs of the bank. (7) It is incumbent upon bank directors in the exercise of ordinary prudence, and as a part of their duty of general supervision, to cause an examination of the condition and resources of the bank to be made with reasonable frequency." Gallin v. National City Bank of New York, 273 N.Y.S. 87, 95, 152 Misc. 679; 7 C.J. 789, note 79 [a].

The other evening I heard a story which I think is apropos of the occasion. A friend of mine over in Virginia has a son eight years old. One afternoon recently while the mother was away the son became engaged with another lad about the same age in a rather violent physical encounter and the subject of this story suffered a brain concussion so it was necessary to rush him to the hospital, where it developed that the injury was not serious and the boy was sufficiently revived so he could go home that afternoon. Meanwhile, of course, his mother had heard about it and on her return home among other questions she asked him, "Who was with you in the ambulance?", and the little boy replied, "Mummie, I do not know. I was not there." When some of the banks that you examiners are checking on get into trouble serious enough to result in a loss resulting from the carelessness or neglect of the directors, the bank director will not be heard to say, "I was not there", and in the last analysis that is the real message that I want to leave with you this morning.