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ADDRESS BY
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BEFORE THE
BANK ADMINISTRATION INSTITUTE
DECATUR, ALABAMA
APRIL 15, 1975

[Abuse of fiduciary obligations]

ANY DISCUSSION OF THE PROBLEMS CREATED BY SELF-DEALING MUST, OF COURSE, BEGIN WITH THE FAILURE OF THE U. S. NATIONAL BANK IN SAN DIEGO. THE FINANCIAL WEB WHICH C. ARNHOLT SMITH SPUN AROUND HIS BANK CONSTITUTED THE MOST MASSIVE AND ARROGANT ABUSE OF FIDUCIARY RESPONSIBILITY IN THE AMERICAN BANKING INDUSTRY.

IN EFFECT, U.S. NATIONAL BANK WAS NOT ONE, BUT TWO BANKS. ONE, AN APPARENTLY SOUND AND EFFICIENT INSTITUTION, SERVED THE SAN DIEGO PUBLIC. THE SECOND PROVIDED CREDIT TO ENTERPRISES RELATED TO OR AFFILIATED WITH THE DOMINANT STOCKHOLDER AND CHAIRMAN OF THE BOARD, IGNORING BOTH SOUND BANKING PRACTICES AND REGULATORY REQUIREMENTS. INVOLVING 200-300 CORPORATE ENTITIES, THESE TRANSACTIONS AMOUNTED TO MORE THAN $400 MILLION. SO INTRICATE AND COMPLEX WAS THIS MAZE OF ENTITIES AND TRANSACTIONS THAT WE ARE NOT YET CERTAIN THAT WE HAVE A COMPLETE PICTURE

OF THE EXTENT OR CHARACTER OF THE WRONGS THAT WERE DONE TO THE DEPOSITORS, CREDITORS AND SHAREHOLDERS OF USNB.

IN THE WORDS OF COMPTROLLER OF THE CURRENCY JIM SMITH, WHAT WAS GOING ON IN THE BANK WAS A VERITABLE ". . .RIOT OF SELF-DEALING." THE RESULT WAS THE WORLD'S FIRST BILLION DOLLAR BANKING INSOLVENCY. IF U.S. NATIONAL WERE THE ONLY INDICATION THAT ABUSIVE SELF-DEALING CONSTITUTES A SERIOUS PROBLEM, IT MIGHT BE DISMISSED AS AN ABERRATION.

HISTORY CLEARLY REFLECTS, HOWEVER, THAT THIS IS NOT THE CASE. ABUSE OF FIDUCIARY OBLIGATIONS BY INSIDERS HAVE BEEN A SIGNIFICANT CAUSATIVE FACTOR IN OTHER LARGE BANK FAILURES. ON JANUARY 25, 1971, THE SHARPSTOWN STATE BANK IN HOUSTON, TEXAS, WITH ASSETS AMOUNTING TO APPROXIMATELY $81 MILLION WAS CLOSED. IT WAS THEN THE SECOND LARGEST FAILURE IN FDIC HISTORY. THE PRIMARY CAUSE WAS THE SELF-SERVING ACTIVITIES OF A DOMINANT STOCKHOLDER. THREE WEEKS LATER IT WAS DROPPED TO THIRD PLACE BY THE FAILURE OF BIRMINGHAM-BLOOMFIELD IN MICHIGAN WHICH, UNTIL USNB, WAS THE LARGEST FAILURE OF AN FDIC-INSURED BANK.

HERE SELF-DEALING WAS COMBINED WITH AN UNSAFE AND UNSOUND INVESTMENT POLICY DICTATED BY THE DOMINANT SHAREHOLDER. UNDER THE EFFECTIVE CONTROL OF THE SAME INDIVIDUAL, DETROIT'S BANK OF THE COMMONWEALTH, WITH DEPOSITS OF JUST OVER $1 BILLION AND TOTAL ASSETS OF $1.26 BILLION, WOULD HAVE FAILED IN 1972 FOR THE SAME REASONS, HAD THE FDIC NOT PROVIDED ASSISTANCE IN THE FORM OF A $35.5 MILLION INFUSION OF CAPITAL UNDER THE PROVISION OF THE ACT WHEREBY THE FDIC CAN ASSIST A FAILING BANK UPON A BOARD FINDING THAT THE BANK IS ESSENTIAL TO THE COMMUNITY WHICH IT SERVES. AND IN OUR MOST RECENT FAILURE OF A RELATIVELY LARGE INSTITUTION, THE $105.9 MILLION ASSET NORTHERN OHIO BANK, SELF-DEALING HAS AGAIN BEEN IDENTIFIED AS AN IMPORTANT CAUSE OF FAILURE.

STATISTICS DEVELOPED BY OUR LIQUIDATION DIVISION REVEAL THAT SELF-DEALING IS NOT LIMITED TO THE SPECTACULAR BANK FAILURE AS AN IMPORTANT CAUSATIVE FACTOR. SINCE JANUARY 1, 1960, 70 BANKS HAVE FAILED. AMONG THESE, SELF-SERVING TRANSACTIONS WERE A SIGNIFICANT FACTOR IN 39, OR 55.5 PERCENT OF THE CASES. DEFALCATIONS, EMBEZZLEMENTS AND MANIPULATIONS CAUSED 21, OR 30 PERCENT OF THE

FAILURES, WHILE MANAGERIAL WEAKNESS IN PORTFOLIO MANAGEMENT ACCOUNTED FOR ONLY 10, OR 14.3 PERCENT. A QUICK REVIEW OF OUR "PROBLEM BANK" FILE REVEALS MUCH THE SAME PATTERN.

STANDING ALONE, EVIDENCE THAT INSIDER TRANSACTIONS ARE A PRIMARY FACTOR IN FAILED AND PROBLEM BANKS WOULD INDICATE THE NEED FOR SPECIAL SCRUTINY OF SUCH TRANSACTIONS BY BOARDS OF DIRECTORS AND FOR INNOVATION IN THE AGENCIES' APPROACH TO INSIDER TRANSACTIONS. CAUSE FOR CONCERN DOES NOT END HERE, HOWEVER. THE CONSEQUENCE OF ABUSIVE SELF-DEALING IN HEALTHY BANKS IS SIMILARLY PERNICIOUS.

ALTHOUGH I KNOW OF NO STUDY OR SURVEY INDICATING THE EXTENT OF "SELF-SERVING" TRANSACTIONS, I DO KNOW, FROM MY EXPERIENCES IN FDIC, THAT THE POTENTIAL FOR ABUSE IS LARGE AND THAT ACTUAL ABUSE, WHILE NOT PERVASIVE, IS MORE WIDESPREAD THAN I, AS A BANKER, IMAGINED. EXAMINATION AND PROBLEM BANK REPORTS REVEAL THAT ALL TOO OFTEN CONTROL GROUPS VIEW THE CONTROLLED BANK AS A PRIVATE MONEY-MACHINE GEARED TO OPERATE AT THEIR PLEASURE ; AND SOUND BANKING PRACTICES, THEIR FICUCIARY

DUTIES AND THE RIGHTS OF MINORITY SHAREHOLDERS BE DAMNED. AS A RESULT, OUR BOARD HAS TAKEN CORRECTIVE ACTION IN RECENT MONTHS IN A NUMBER OF CASES INVOLVING "SWEETHEART" LEASES; PREMIUMS PAID OR DISCOUNTS MADE IN THE PURCHASE OR SALE OF ASSETS; AND EXORBITANT FEES FOR MANAGEMENT CONSULTING OR ATTORNEY FEES.

A CASE PRESENTLY BEFORE THE CORPORATION REFLECTS A PROBLEM WHICH MAY BE A SERIOUS AND RECURRING ONE IF NOT NIPPED IN THE BUD. CHANGING THE FACTS SOMEWHAT, THE FOLLOWING HYPOTHETICAL POSES THE PROBLEM. THE HOLDING COMPANY OWNS 80 PERCENT OF BANK A'S STOCK AND PROVIDED MANAGEMENT SERVICES TO THE BANK UNDER A CONTRACT. WHEN BANK B, ANOTHER SUBSIDIARY BANK, SUFFERED SEVERE LOAN LOSSES WHICH IMPAIRED CAPITAL, THE HOLDING COMPANY INCREASED SUBSTANTIALLY ITS MANAGEMENT FEE TO GENERATE REVENUE IN ORDER TO DOWNSTREAM FUNDS TO BANK B. THIS COULD BE ACOMPLISHED, OF COURSE, SINCE AS 80 PERCENT SHAREHOLDER THE HOLDING COMPANY IN EFFECT SAT ON BOTH SIDES IN REFORMING THE MANAGEMENT CONTRACT. THUS, IN ORDER TO RAISE FUNDS TO BUTTRESS THE CAPITAL OF THE AILING INSTITUTION, THE HOLDING

COMPANY HAS LOOTED BANK A RESULTING IN A DEPLETION OF ITS CAPITAL POSITION AND FINANCIAL DETRIMENT TO MINORITY SHAREHOLDERS.

THE HARM WHICH FLOWS FROM SUCH TRANSACTIONS SHOULD NOT BE IGNORED. WHEN AN INSIDER, WHETHER AN INDIVIDUAL, A CONTROL GROUP, OR A HOLDING COMPANY, RECEIVES ECONOMIC BENEFIT OVER AND AND ABOVE THAT WHICH A NON-INSIDER WOULD HAVE RECEIVED IN AN ARM'S LENGTH MARKET TRANSACTION, A BANK IS NECESSARILY ADVERSELY AFFECTED. THIS IS TRUE EVEN IF THE INSIDER HAS NO CONSCIOUS INTENTION TO MILK HIS BANK. MANY OF THE ABUSES IN THIS AREA FLOW FROM A FACT OF ECONOMIC LIFE APTLY DESCRIBED BY PROFESSOR E. MERRICK DODD IN 1940 IN TESTIMONY BEFORE THE SENATE BANKING AND CURRENCY COMMITTEE. HE SAID:

> "NOW A MAN MAY BE ON BOTH SIDES OF A BARGAIN AND STILL BE HONEST, BUT A MAN CANNOT BE ON BOTH SIDES OF A BARGAIN WITHOUT HAVING HIS JUDGMENT AFFECTED BY THAT FACT."

WHETHER THE RESULT OF CONSCIOUS OVERREACHING OR TAINTED JUDGMENT, THE ECONOMIC BENEFIT WHICH REDOUNDS TO THE INSIDER OVER AND ABOVE

THAT WHICH WOULD HAVE BEEN GENERATED IN AN ARM'S LENGTH TRANSACTION REPRESENTS A COST OR LOSS OF EARNINGS TO THE BANK. THIS COST OR LOSS IS BORNE BY NON-BENEFITING SHAREHOLDERS AND SERVES TO DEPLETE THE BANK'S CAPITAL ACCOUNTS.

ACCORDINGLY, ANY TRANSACTION BETWEEN AN INSIDER OR HIS INTERESTS AND A BANK WHICH IS SIGNIFICANTLY MORE FAVORABLE TO THE INSIDER THAN A COMPARABLE TRANSACTION WITH A NON-INSIDER IS NOT A SOUND BANKING PRACTICE AND SHOULD, WITHIN THE LIMITS OF OUR RESOURCES, BE THE SUBJECT OF FIRM SUPERVISORY ACTION. TO FOLLOW ANY OTHER POLICY IS TO ALLOW BANKS TO SUBSIDIZE THE NON-BANKING FINANCIAL ACTIVITY OF PREFERRED INSIDERS AT THE ULTIMATE EXPENSE OF MINORITY OR NON-INTERESTED SHAREHOLDERS AND, IN THE CASE OF BANK FAILURE, AT THE EXPENSE OF MANY CREDITORS AND DEPOSITORS AS WELL.

WHILE IT IS DIFFICULT TO EVALUATE ITS IMPACT, A SECOND CONSEQUENCE FLOWS FROM ALLOWING A BANK'S FIDUCIARIES TO EXEMPT THEMSELVES FROM THE DISCIPLINE OF THE MARKET. NOT ONLY ARE A BANK'S ASSETS OFTEN WASTED, BUT THE ALLOCATION OF A COMMUNITY'S

RESOURCES AS REPRESENTED BY THE BANK'S DEPOSITS CAN BE MISALLOCATED OR ALLOCATED IRRATIONALLY. THE CONSTRUCTION AND OPERATION OF THE WESTGATE PLAZA HOTEL, SAID BY MANY TO BE ONE OF THE FINEST HOTELS IN THE WORLD, IS ILLUSTRATIVE. CAPITAL COSTS PER ROOM HAVE BEEN ESTIMATED AT MORE THAN $100,000 AND THE OPERATION WAS LAVISH TO SAY THE LEAST. IT IS, I ASSURE YOU, A VERY FINE HOTEL. IT WAS, HOWEVER, NOT A SOUND BUSINESS ENTERPRISE, AND IT IS HIGHLY DOUBTFUL THAT IT WOULD HAVE BEEN BUILT OR RUN AS IT WAS IF USNB AND OTHER ENTERPRISES RELATED TO THE INTERESTS OF THE DOMINANT SHAREHOLDER HAD NOT STOOD READY TO, AND DID, SUBSIDIZE THE OPERATION OF THE HOTEL.

COMMERCIAL BANKS ARE CHARTERED TO SERVE A SPECIFIC BANKING FUNCTION IN THE ECONOMY. THEY ARE NOT CHARTERED TO PROVIDE PREFERENTIAL TREATMENT TO INSIDERS SO THAT THEY CAN ADVANCE THEIR OWN OR OTHER BUSINESS INTERESTS. IN THE COMPETITIVE FREE ENTERPRISE SYSTEM, PROFIT AND COMPENSATION SHOULD FLOW TO BANKERS AS A RESULT OF THEIR EFFECTIVELY CARRYING ON THE BUSINESS OF BANKING AND NOT FROM THEIR USE OF THE INSTITUTION TO GAIN

ECONOMIC ADVANTAGE WHICH COULD NOT BE GAINED INDEPENDENTLY. AS WE HAVE SEEN, WHERE THESE LEGAL AND INSTITUTIONAL PRINCIPLES ARE FORGOTTEN, DISTORTIONS OCCUR WHICH MAY RANGE FROM THE FAILURE OF A BILLION DOLLAR BANK TO A BALKING OF MINORITY SHAREHOLDERS. WHETHER THE CONSEQUENCE IS LARGE OR RELATIVELY SMALL, THERE IS A STRONG SOCIETAL INTEREST IN INSISTING THAT BANKERS PLAY BY THE RULES OF THE GAME.

TWO GENERAL APPROACHES MIGHT BE TAKEN BY THE BANKING AGENCIES TO CURB ABUSE IN THIS AREA. ON ONE HAND, INSIDER TRANSACTIONS OF A CERTAIN KIND OR MAGNITUDE MIGHT BE FORBIDDEN OR SIGNIFICANTLY LIMITED. THIS IS ESSENTIALLY THE APPROACH WHICH THE FEDERAL HOME LOAN BANK BOARD HAS ADOPTED IN ITS PROPOSED CONFLICT OF INTEREST REGULATIONS. THIS WOULD NOT ONLY ELIMINATE THE INSIDER'S ADVANTAGE VIS-A-VIS THE PUBLIC, BUT ALSO PLACE HIM AT A DISADVANTAGE. THE SECOND APPROACH WOULD SEEK TO INSURE THAT INSIDERS DERIVE NO BENEFIT NOT AVAILABLE TO NON-INSIDERS. IN ESSENSE, THIS IS THE APPROACH PRESENTLY FOLLOWED AT THE FDIC; AND IT IS THE ONE WHICH I FAVOR. HOWEVER, SUPERVISION MIGHT BE MADE MORE RIGOROUS.

Last summer, the Comptroller's Office issued for comment a proposed regulation aimed at facilitating the curbing of abuses in this area. Generally, the regulation required all national bank directors and principal officers to keep on file at the bank a written statement of their ourside business interests and of any extension of credit or other transaction between those interests and the bank. According to the Comptroller's "Notice of Proposed Rule Making:"

> "The purpose of this Regulation is to establish an informational base upon which bank management and the Comptroller's Office may assess more accurately the extent and manner by which a national bank may be engaging in transactions with its own directors and senior officers."

After receiving extensive comment with respect to the regulation, the Comptroller revised the regulation somewhat and made it effective as of March 15, 1975.

It should be noted that the bulk of the comments

GENERALLY FAVORED THE MAIN THRUST OF THE REGULATION. FOR EXAMPLE, THE CAPITAL NATIONAL BANK OF AUSTIN, TEXAS POINTED OUT:

> ". . . THAT VIRTUALLY EVERY RECENT BANK FAILURE IN THE UNITED STATES HAS BEEN DIRECTLY OR INDIRECTLY THE RESULT OF SOME CONFLICT-OF-INTEREST SITUATION. IT IS UNFORTUNATE THAT THE BANKING PROFESSION HAS NOT TAKEN IT UPON ITSELF TO ESTABLISH A CODE OF ETHICS WHICH WOULD PREVENT SUCH SITUATIONS FROM RECURRING."

THE AMERICAN BANKERS ASSOCIATION ANNOUNCED ITS "BASIC AGREEMENT" WITH THE GOALS OF THE REGULATIONS, BUT PROPOSED CERTAIN SPECIFIC CHANGES, EMPHASIZING THAT "IT IS IMPERATIVE ON THE PART OF THE COMPTROLLER TO INSURE THAT BANK DIRECTORS AND PRINCIPAL OFFICERS ARE NOT OVERLY BURDENED WITH REPORTED THIS TYPE OF INFORMATION."

AS I HAVE INDICATED ELSEWHERE, I STRONGLY SUPPORT THE PROMULGATION OF REGULATIONS AIMED AT CURBING THE ABUSES OF SELF-DEALING. TO DO OTHERWISE IS TO IGNORE THE LESSONS OF RECENT BANKING HISTORY. I FAVOR A SOMEWHAT BROADER APPROACH THAN THAT

OF THE COMPTROLLER. AT THE SAME TIME, I AGREE WITH THE ABA THAT REPORTING REQUIREMENTS SHOULD BE KEPT AT THE ABSOLUTE MINIMUM CONSISTENT WITH EFFECTIVE REGULATION.

FIRST OF ALL, I WOULD REQUIRE THAT INSIDER TRANSACTIONS WHICH ARE OF SIGNIFICANT SIZE AND NON-ROUTINE NATURE BE APPROVED BY THE BANK'S BOARD OF DIRECTORS AND THAT SUCH VOTE BE RECORDED IN THE BOARD'S MINUTES. SECOND, IT SHOULD BE MADE PLAIN THROUGH REGULATION THAT ANY TRANSACTION BETWEEN AN INSIDER OR HIS INTERESTS WHICH, TAKING INTO ACCOUNT ALL RELEVANT ECONOMIC CIRCUMSTANCES, IS MORE FAVORABLE TO THE INSIDER THAN A COMPARABLE TRANSACTION WITH A NON-INSIDER IS AN "UNSAFE OR UNSOUND" BANKING PRACTICE WITHIN THE MEANING OF SECTION 8 OF THE FEDERAL DEPOSIT INSURANCE ACT. THE STATEMENT OF SUCH A STANDARD IN REGULATIONS HAVING THE FORCE OF LAW WOULD, IT SEEMS TO ME, PROVIDE BANK BOARDS WITH A CLEAR BENCHMARK AND INCENTIVE FOR CAREFULLY CONSIDERING INSIDER TRANSACTIONS AND REJECTING THOSE WHICH ARE UNFAIR TO THE BANK.

AT THIS JUNCTURE I SHOULD EMPHASIZE THAT SUCH A STANDARD WOULD NOT CONSIST OF A MECHANISTIC TEST FOCUSING ONLY ON THE TERMS

OF THE TRANSACTIONS. RATHER THE TEST SHOULD BE WHETHER THE TRANSACTION BEARS THE EARMARKS OF AN ARM'S LENGTH BARGAIN IN LIGHT OF ALL THE SURROUNDING CIRCUMSTANCES IN MANY CASES, APPARENTLY PREFERENTIAL TERMS, SUCH AS LOWER INTEREST RATES, CAN BE JUSTIFIED BY CIRCUMSTANCES NOT APPEARING ON THE FACE OF THE LOAN AGREEMENT. WHERE THAT IS THE CASE AND THERE IS NO DETRIMENT TO THE BANK, AN INSIDER TRANSACTION IS NOT OBJECTIONABLE AND SHOULD NOT BE THE FOCUS OF REGULATORY CONCERN OR ACTION.

THE FDIC PRESENTLY TAKES CORRECTIVE ACTION WHEN OVERREACHING IS DISCOVERED IN REVIEW OF AN APPLICATION FOR BRANCH APPROVAL, DEPOSIT INSURANCE OR ONE OF THE OTHER APPLICATIONS WHICH THE BOARD MUST SCRUTINIZE. FOR EXAMPLE, A BRANCH APPLICATION REFLECTING A "SWEETHEART LEASE" BETWEEN A BANK AND AN INSIDER OR HIS INTERESTS WILL NOT BE APPROVED. WITH ALL INSIDER TRANSACTIONS DISCLOSED TO SUPERVISORY PERSONNEL, THIS POLICY WOULD BE APPLIED MORE SYSTEMATICALLY. WHERE VOLUNTARY COMPLIANCE WITH THE STANDARD EMBODIED IN THE REGULATION IS NOT FORTHCOMING, A CEASE AND DESIST ORDER UNDER SECTION 8(B) OF THE CORPORATION'S ACT IS AN EFFECTIVE

VEHICLE FOR ENFORCEMENT. MOREOVER, THE EXISTENCE OF A STANDARD OF CONDUCT SPELLED OUT IN THE REGULATIONS MIGHT FACILITATE RECOVERY IN A DERIVATIVE ACTION WHERE AN INSIDER VIOLATES HIS FIDUCIARY DUTY TO THE BANK OR WHERE A BANK'S BOARD DOES NOT ADEQUATELY POLICE THE CONFLICTS OF INTEREST WHICH ARE INEVITABLE IN THE BANKING BUSINESS.

FINALLY, I MUST ADMIT THAT THE QUESTION OF DISCLOSURE AND REPORTING REQUIREMENTS IS A DIFFICULT ONE FOR ME AS A FORMER BANKER. THE PRIVACY OF INDIVIDUALS AND THE NEED TO AVOID COSTLY AND TIME-CONSUMING REPORTING PROCEDURES MUST BE BALANCED WITH THE DEMONSTRATED NEED TO CURB ABUSE BY INSIDERS IN THIS AREA. GREAT CARE SHOULD BE TAKEN TO AVOID CREATION OF A COMPLEX SET OF DISCLOSURE PROCEDURES WHICH BECOME AN END IN THEMSELVES AND DO LITTLE TO ADVANCE THE ULTIMATE END OF THE REQUIREMENT. ON THE OTHER HAND, THE NATURE AND SERIOUSNESS OF THE PROBLEM NECESSARILY REQUIRES A CERTAIN AMOUNT OF DISCLOSURE AND REPORTING.

THE PARAMOUNT NEED IS THAT INSIDER TRANSACTIONS SHOULD BE FLAGGED FOR THE BANK'S BOARD AND EXAMINER PERSONNEL. AS I

HAVE INDICATED, THE COMPTROLLER'S REGULATION SEEKS TO ACCOMPLISH THIS THROUGH REQUIRING CERTAIN INSIDERS TO DISCLOSE THESE INTERESTS AND ANY SIGNIFICANT TRANSACTIONS WITH THE BANK. I WOULD REQUIRE THAT INSIDERS GIVE NOTICE TO THE BANK'S BOARD SUFFICIENTLY FAR IN ADVANCE OF THE TRANSACTION TO ALLOW THE BOARD TO GIVE IT DUE CONSIDERATION. IN ADDITION, I WOULD REQUIRE THAT BOARD APPROVAL OF INSIDER TRANSACTIONS BE SUPPORTED BY INFORMATION RECORDED IN THE MINUTES DEMONSTRATING THE FAIRNESS OF THE TRANSACTION AND THAT SUCH INFORMATION BE READILY AVAILABLE TO EXAMINER PERSONNEL. ALSO, I WOULD SEEK TO BRING DOMINANT AND SUBSTANTIAL SHAREHOLDERS WITHIN THE SCOPE OF THE REGULATION. TO INSURE ACCURATE AND COMPLETE DISCLOSURE THE AGENCIES MUST DEMONSTRATE THE CLEARCUT INTENTION TO IMPOSE CRIMINAL AND CIVIL SANCTIONS WHEN THE REQUIREMENTS ARE NOT COMPLIED WITH.

ULTIMATELY, HOWEVER, THE MOST EFFECTIVE CHECK ON ABUSE BY INSIDERS IS A BOARD OF DIRECTORS WITH SUFFICIENT INFORMATION, INQUISITIVENESS, AND INDEPENDENCE TO SCRUTINIZE CRITICALLY AND PASS UPON A BANK'S DEALINGS WITH INSIDERS AND THEIR INTERESTS.

WHILE JUDICIAL PRONOUNCEMENTS REGARDING DIRECTORS' RESPONSIBILITIES AND LIABILITIES DO NOT DESCRIBE A MODE OF CONDUCT WHICH WILL APPLY TO ALL CIRCUMSTANCES, IT IS POSSIBLE, I BELIEVE, TO ARTICULATE CERTAIN GUIDELINES WHICH SURELY CONSTITUTE REASONABLE DILIGENCE AND GOOD FAITH IN THE TREATMENT OF INSIDER TRANSACTIONS.

FIRST, A DIRECTOR SHOULD INSIST THAT HE HAVE ADEQUATE INFORMATION TO EVALUATE THE SOUNDNESS OF THE BANK'S DEALINGS WITH INSIDERS. WHETHER SUPERVISORY AUTHORITIES REQUIRE IT OR NOT, IT SEEMS TO ME THAT THE BANK'S BOARD SHOULD:

(1) REQUIRE THE REPORTING TO THE BOARD OF ALL SIGNIFICANT INTERESTS OF DIRECTORS, OFFICERS, OTHER KEY EMPLOYEES AND SUBSTANTIAL SHAREHOLDERS WHO ARE NOT MEMBERS OF THE BOARD;

(2) REQUIRE THE REPORTING TO THE BOARD OF ALL SIGNIFICANT TRANSACTIONS BETWEEN SUCH INDIVIDUALS AND THE BANK, INCLUDING SUFFICIENT INFORMATION ON WHICH TO BASE AN INDEPENDENT JUDGMENT WITH RESPECT TO THE FAIRNESS OF THE TRANSACTION VIS-A-VIS THE BANK; AND

(3) Require board approval of all or certain insider transactions and the establishment of procedures to insure the proper treatment of those for which approval is not required.

Second, in assessing a transaction between a bank and an insider, each director should satisfy himself that the transaction is a fair one and that the insider has not derived benefit at the bank's expense by virtue of his relationship to the bank. In making this judgment, it is well to recall the statement of the Supreme Court in the case of Pepper v. Litton. There the Court addressed the matter of who must bear the proof in a court of law where an insider transaction was challenged. It seems to me that a director should engage in much the same critical exercise in his own review of an insider transaction. The Court stated:

"A director is a fiduciary . . . . So is a dominant or controlling stockholder or group of stockholders . . . . Their dealings with the corporation are subjected to

> THE SAME RIGOROUS SCRUTINY AND WHERE ANY OF THEIR CONTACTS OR ENGAGEMENTS WITH THE CORPORATION IS CHALLENGED THE BURDEN IS ON THE DIRECTOR OR STOCKHOLDER NOT ONLY TO PROVE THE GOOD FAITH OF THE TRANSACTION BUT ALSO TO SHOW ITS INHERENT FAIRNESS FROM THE VIEWPOINT OF THE CORPORATION AND THOSE INTERESTED THEREIN. . . . THE ESSENCE OF THE TEST IS WHETHER OR NOT UNDER ALL CIRCUMSTANCES THE TRANSACTION CARRIES THE EARMARKS OF AN ARM'S LENGTH BARGAIN."

I AM AWARE THAT PREFERENTIAL CREDIT TERMS OR A PREMIUM PAID FOR ASSETS ARE OFTEN VIEWED AS A MEANS OF SUPPLEMENTING THE COMPENSATION OF AN INSIDER OR AS ONE OF THE BENEFITS OF ASSOCIATION WITH A BANK. HOWEVER, THE STANDARD TO BE APPLIED SHOULD BE THAT OF THE MARKET AND, WHERE THE PARTY ON THE OTHER SIDE OF A DEAL IS AN INSIDER, A DIRECTOR SHOULD TAKE SPECIAL CARE TO SATISFY HIMSELF THAT THE TERMS AND CONDITIONS OF THE TRANSACTIONS ARE AT LEAST AS FAVORABLE TO THE BANK AS THEY

WOULD HAVE BEEN HAD THE DEAL BEEN NEGOTIATED WITH A NON-INSIDER. APPLICATION OF A LESS RIGOROUS STANDARD IS, IN EFFECT, TO ALLOW A WASTING OF BANK ASSETS.

FINALLY, IT IS IMPORTANT TO EMPHASIZE THE NECESSITY OF EACH BOARD MEMBER'S EXERCISING AND EXPRESSING HIS OWN INDEPENDENT JUDGMENT. WHENEVER A BANK DIRECTOR FUNCTIONS AS A RUBBER STAMP FOR MANAGEMENT OR CONTROLLING INTERESTS, OR MERELY GOES ALONG WITH THE MAJORITY AS A RESULT OF RETICENCE OR IGNORANCE, HE HAS CEASED TO SERVE HIS INSTITUTIONAL FUNCTION AND HAS THEREBY ABDICATED HIS LEGAL RESPONSIBILITY. IT HAS BEEN SAID AND I AGREE THAT THERE ARE TIMES WHEN A "DIRECTOR SHOULD RISK HIS POSITION TO THE EXTENT OF BRINKMANSHIP IF HE IS TO CONTRIBUTE TO THE WELFARE OF THE BANK AND TO DISCHARGE HIS TRUST." WHERE DEALINGS BETWEEN A BANK AND INSIDERS ARE INVOLVED, THE NEED FOR SUCH INDEPENDENCE IS COMPOUNDED. IT IS WELL TO RECALL THAT A COMMON ELEMENT IN MANY MAJOR BANK FAILURES OF RECENT YEARS HAS BEEN A SINGLE INDIVIDUAL WHO DOMINATED HIS BOARD.

IN CONCLUSION, I SHOULD EMPHASIZE THAT I DO NOT MEAN

TO BE A DOOMSDAY PROPHET NOR TO SUGGEST THAT INSIDER TRANSACTIONS ARE BAD PER SE. ON THE CONTRARY, THE VAST MAJORITY OF SUCH RELATIONSHIPS ARE MORE THAN FAIR TO THE BANK CONCERNED. INDEED, IN MANY COMMUNITIES, DEALINGS BETWEEN A BANK AND ITS DIRECTORATE ARE THE LIFE BLOOD OF THE INSTITUTIONS. AT THE SAME TIME, WE MUST RECOGNIZE THAT OVERREACHING DOES OCCUR, WHETHER THE RESULT OF TAINTED JUDGMENT OR DISHONESTY, AND THAT ITS IMPACT CAN BE SEVERE, AS IT WAS IN SAN DIEGO. ACCORDINGLY, IT SEEMS TO ME THAT BOTH THE BANKING AGENCIES AND BANK BOARDS OF DIRECTORS SHOULD MOVE VIGOROUSLY TO CURB THE ABUSES WHICH--THOUGH RELATIVELY RARE IN OUR NEARLY 15,000 BANKS--DO OCCUR AND HAVE ADVERSE CONSEQUENCES FOR THE SOUNDNESS OF INDIVIDUAL BANKS, FOR MINORITY SHAREHOLDERS, AND FOR CONFIDENCE IN OUR BANKING SYSTEM.

BECAUSE WE AT THE FDIC ARE ACTIVELY CONSIDERING THESE ISSUES, I WOULD GREATLY APPRECIATE YOUR THOUGHTS ON THE SUBJECT. I THANK YOU FOR INVITING ME TO SHARE MY THOUGHTS WITH YOU.

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