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Responsibilities of a Bank Director

Most of you are aware of the safeguards suggested by various banking organizations for establishing a successful loss prevention program in banks. As bankers, you know the value of maintaining a variety of internal controls and the use of outside audit firms and you are aware of the importance of direct verification of accounts with customers and correspondent banks. You also know the prime requisites for maintaining a sound loan policy and establishing a profitable but secure investment program. Recently, we have all become aware of the hazards of brokered deposits when these funds are used in making unsafe or self-serving loans.

Being a part of the Liquidation Division of the Federal Deposit Insurance Corporation, we become quite aware of where bank losses are likely to occur and the importance of a loss prevention program in every bank. As bank liquidators, we are very often faced with the question of what responsibilities a bank director has for preventing losses. Being elected a director of a commercial bank means that you have been elected to a position of honor, but it does carry with it certain legal responsibilities. After an insured bank has been closed by either the state banking authority, if it is a state bank, or the Comptroller of the Currency, in the event it is a national bank, the Federal Deposit Insurance Corporation, because of the fiduciary duties imposed upon it in its capacity as receiver of the closed institution, must of necessity consider whether any legal liability has been incurred by the directors of the particular bank.

When a bank director takes his oath of office he swears he will do his best to manage his bank in such a way that the statutory law applicable to it will not be violated. It is, therefore, important that the director become familiar with the statutes applicable to his particular bank, and not violate them. If he conducts the affairs of his bank within the statutory framework, heeds all warnings that may come to him from whatever source concerning things that may be going wrong in the bank by making the proper checkup in connection with any warnings from bank examiners, the state banking authority, or anyone else, and if a director does not abandon his duties and functions, the chances are extremely remote that he will find himself a defendant in a directors' liability suit. If nothing else is remembered from my remarks, remember these three

phrases:

(1) A director should make sure the bank abides by the statutes applicable to it;

(2) He should not abandon his very important duties and functions; and

(3) He should heed any warnings he may receive as to any improprieties that may or may not be occurring in connection with the bank's operations.

In general, the directors and other corporate officers of a bank may be held personally liable for

(1) a breach of trust,

(2) negligence, the proximate cause of losses,

(3) acts in excess of their powers,

(4) fraud, and

(5) misappropriation or conversion of the bank's assets.

The liability of directors and other officers of a bank is determined substantially by the same principles which determine liability of any agent to a principal for failure to perform his duties. From the standpoint of imposing directors' liability in the case of a closed bank where the facts are such that fraud, misappropriation, conversion, or breach of trust may be clearly shown, a relatively simple situation presents itself where it is obvious to everyone that liability exists. The difficulties usually arise in cases involving negligence which falls short of breach of trust or fraud. While the applicable principles in these cases are easy enough to state, their application to factual situations presents difficulties, in that courts from time to time, after stating the principles, have either found liability or no liability, with no real criterion set out for the difference in the result.

There are generally two bases of liability of a director, one for failure to exercise that degree of care which ordinarily diligent and prudent men would exercise under the circumstances, and one which provides that directors who shall knowingly violate, or knowingly permit any of the officers or agents of the bank to violate any of the provisions of banking regulations shall be

personally liable for all damages which the bank, its shareholders, or any other person shall have sustained as a result of such violation.

An example of a breach of official duty is when a president and director of a bank causes his bank to accept and approve the notes of his son, which otherwise would not have been accepted, through his assurances to other officers of the bank that he personally would be responsible for the indebtedness in question. The directors of a bank are guilty of a plain breach of duty if they retain in a responsible position a man who has shown himself to be unworthy of trust.

It is well settled that bank directors or other officers may render themselves personally liable for negligence in the making of loans which result in loss to the corporation, and this liability may result either from making of the loan, from renewing it, or in failing to collect it, if they are guilty of any want of ordinary care in the making of loans on behalf of the bank which causes it loss. They are, of course, liable where they have either wilfully or negligently made bad loans resulting in loss to the corporation.

If directors of a bank make loans to persons known to be insolvent, the directors are liable to the bank for the loss. Directors of a bank who own a majority of the capital stock can be held liable if they permit improvident and excessive loans to be made by the bank officers to the original directors themselves and their interests, causing the bank to become insolvent.

There have been cases where officials of a bank permitted large overdrafts by a corporation known to be financially embarrassed, and they were held liable by the court for the amount so lost.

When reviewing directors' liability, it is essential that consideration be given to negligence of directors. It perhaps would be most helpful to you to have a brief review of particular acts with respect to whether or not they constitute negligence. The following are some examples:

(1) A president who has willingly, by culpable negligence, received forged municipal bonds is personally liable for the loss.

(2) Acceptance by the president, a director of the bank, of doubtful securities in payment of good debts is negligence.

(3) Authorization for the purchase of a large amount of commercial paper affected with a patent infirmity, creates liability.

(4) The directors of banks are negligent and liable when they fail to heed the warning of the Bank Commissioner.

(5) Directors have been held clearly negligent in failing to hold meetings, as required by the bylaws of the bank, and failing to obtain a statement of the financial condition of the bank.

(6) Directors have been held negligent and liable for refusing or omitting to proceed against their predecessors in office to recover losses sustained by the latter's negligence.

(7) Bank directors have been held guilty of negligence in paying dividends when the capital had been impaired and when reserves were deficient.

(8) It has been held that a director who never makes, or causes to be made, any examination whatever of the books and papers of the bank to determine its condition and the way in which it is being conducted does not exercise ordinary care and prudence in the management of the bank and cannot be shielded from liability because of his alleged want of knowledge of wrongdoing, as his ignorance was the result of gross inattention in the discharge of his voluntary and sworn duty.

(9) Bank directors have been held negligent for failure to appoint a committee to audit the affairs of the bank, and for relying on the integrity of the president of the bank without causing an examination to be made of the bank's books and papers.

(10) The mere failure of a director to attend a specific meeting of the board is not necessarily negligence. On the other hand, it is not open to doubt, that a wilful and continued failure on the part of a director to attend meetings of the board at which the business of the bank is conducted, and to familiarize himself, to some extent, with the bank's affairs, is a violation of the duty which the common law imposes upon directors and, if loss results therefrom, that he is liable, because such action is, in itself, a failure to exercise the ordinary care and prudence in the administration of affairs of the bank which the law imposes upon directors.

Considering the numerous duties with which a bank director is charged and the penalties for their neglect, it may seem strange that enough public spirited individuals can be found in a community to undertake the job when considering that the remuneration is relatively nominal. The answer to this is that the director who exercises reasonable and ordinary care does not expose himself to the penalties of the law. This does not mean that the board of directors can safely rely on the bank's officers and the reports of the bank examiners of the Comptroller, Federal Reserve Board, FDIC, or state authorities. For the board of directors and its committees to do their duty with reasonable care requires more than just regular attendance at meetings. Much careful work must be done by or for the board. Here let me emphasize that we do not assert a claim for directors' liability because of the failure of the directors to uncover an embezzlement or a misapplication of funds. The claim for directors' liability is asserted when the directors fail to perform the functions which are required by law or under the bylaws of the particular bank.

In our efforts to determine whether a claim exists against the directors in a closed bank we examine the following:

1. The functioning of the examination committee during the decade preceding the closing of the bank.

2. The pertinent bylaw provisions governing the duties of such committees.

3. The dates of its meetings showing their regularity.

4. The extent to which its reports were referred to and considered by the board, like information on the loan and discount committee.

5. The regularity with which board meetings were held and the pattern of attendance at those meetings and the nature of the business acted upon thereat as reflecting the degree of attention being given to the affairs of the bank.

6. The extent to which the board considered and acted upon correspondence from, and reports of examination by, the supervisory authorities, particularly where criticisms are contained in those communications.

7. The extent to which there were red flags or irregularities, that is, abnormal fluctuations in savings and checking account totals, in the volume and nature of the loan portfolio.

8. In the amount of holdings of U. S. and other public securities and in the totals of correspondent bank balances, all as shown by the records and books of the bank.

9. Any knowledge of irregular acts on the part of officers and employees and action taken as a result of such knowledge. Many other areas, such as notoriety in high living on the part of relatively low-salaried officers, normally are sifted with care to see whether a directors' liability action is justified.

In a bank, the director's duty is to direct and not to be led. The officers are charged with carrying out the director's policies, but it is not enough for the directors to lay down the policies. They must be ever alert to insure that the policies are being faithfully, ably, and honestly executed by bank personnel.

While it may be distasteful at times to assert a director's liability claim, it is mandatory that a liquidator do so if the basis for a claim is discovered. The supervisory authorities must accept their responsibilities and the officers of banks, as well as directors, must also assume their responsibilities if our system of banking is to survive and prosper.

In conclusion, I would like to stress one thought. If a director always remembers he is a manager of other people's money, he is ready to accept the responsibilities of being a director.

Thank you for my invitation to speak before your group.

We have often heard the term "growth industry" applied to many segments of business, including banking. Not many of us think of bank fraud as such a growth industry; however, whether we as members of the banking profession like to admit it or not, embezzlements constitute one of America's fastest growing enterprises.

In 1970, there were 4,125 Federal Reserve Act violations reported to the Federal Bureau of Investigation, a new all time high. The amounts involved in these cases totaled almost $73 million, more than double the 1969 record of $33 million involved in 3,773 such cases. Federal Reserve Act violations are those perpetrated by bank officials and employees by way of embezzlements, abstractions and related offenses.

Statistics on major frauds, that is, those exceeding $10,000 clearly show there is a greater danger to operating banks from inside manipulations by officers and employees than those external hazards such as bank robbery.

Year	No. Cases	Total Amount	Holdup and Burglary Amount
1970	245	$ 32,700,000	$ 12.6 million
1969	180	16,900,000	9.1 million
1968	146	11,200,000	10.5 million

Records are being set in this area also.

Another measure of fraud is insured bank closings which are the direct responsibility of the Division of Liquidation of the Federal Deposit Insurance Corporation which I head.

Historically, banks close in good times and bad. Since FDIC began operations on January 1, 1934 to date, there have been 495 insured bank closings. In about a quarter of these cases, defalcations, or to use another term, embezzlements, have been the direct cause of the closings. If we exclude those failures in our early years which were carry-overs from the Great Depression, the causes of closing in the remaining cases range from poor judgment in making loans coupled with lax collection policies in a few cases to circumstances bordering on outright fraud. The fraudulent practices leading to some of the closings occurred both from inside and outside of the bank. There have been no banks closed in recent times which were due principally to economic factors related to the economy.

During the approximate 12 year period from January 1, 1960 to date, there have been 56 insured bank failures and the average for the period would be about 4.6 failures per year. The largest bank in this group on the deposit side had total deposits of $93 million, and the smallest total deposits of $435 thousand. On the asset side, the largest failure during this period and in FDIC's history was the Birmingham Bloomfield Bank, Birmingham, Michigan with total assets of $113.4 million. The smallest had total assets of $479 thousand.

It is difficult in many cases to assign a proximate cause for a particular bank closing since, by the time a bank reaches the point of failure, it has usually had a number of problems which contribute to the failure. With this in mind, let's examine the major causes of failure assigned to these 56 banks:

19 were due to self-serving loans to the bank's management coupled in some cases with bad loans from out of the bank's trading areas and a contributing factor in all cases was the misuse of brokered funds. (34%)

14 were as a direct result of defalcations or embezzlement by bank officials or employees. (25%)

13 were due to self-serving loans to bank management. (23.2%)

5 were due to bad loans coupled in most cases with lax collection efforts. (9%)

2 were the result of bad loans to out-of-territory borrowers. (3.5%)

3 were due to various manipulations by bank officials. (5.3%)

Getting a little more specific, here are some of the acts which contributed to the insolvency of the various banks:

New ownership and looting

Check kiting operations

Collusion with borrowers

Forged and fictitious notes

Misuse of bank funds

Fraudulent use of blank unissued stock certificates

Self-serving financial operations

Deposit ledger shortages

Loans to questionable borrowers

Improper loan disbursements

False loan collateral

Shortage in unearned discount

Excessive charges to expense accounts

Speculative real estate loans

Holding of NSF and other checks in Cash Items

High risk home improvement loans

Real estate loans disbursed in full before construction of properties

Loans on nonexistent or hard to locate collateral

Questionable contingent liabilities

Poor judgment and lax collection policies

Various illegal practices

Liberal or hazardous lending policies

Overinvestment in long-term securities with resultant depreciation

Forward loan commitments

Unwarranted payments of cash dividends to controlling element based on unrealized projected income

Manipulations of correspondent bank accounts

Loans in excess of legal lending limits

Use of phantom borrowers with diversion of loan proceeds

Misuse of blank official checks

Returning again to the major causes of failure attributed to the 56 banks closed during the study period, we find it is possible to generally group the failing banks into three basic categories:

1. (34 cases) Improper loans to officers, directors, or owners or loans to out-of-territory borrowers -- misuse of brokered funds in 19 cases. (60.7%)
2. (17 cases) Defalcation, embezzlement or manipulation cases. (30.3%)
3. (5 cases) Managerial weaknesses in loan portfolio management. (9%)

There are common factors which are usually found in all of the closed banks -- weak, disinterested, uninformed or fraudulent management; a lack of or insufficient internal routines, controls and operating systems; and in many cases "poor housekeeping." Most of the banks did not have an internal auditor, or in smaller banks some employee who performed essential audit functions. As to the use of audits by outside firms, a recent study of the 22 banks which closed

from January 1, 1969 to date disclosed that 11 of the 22 banks had an outside audit of some kind, therefore, the result here is mixed with one-half in each category.

Generally speaking, directors of the closed banks, in some cases with cause, abandoned their vital duties and functioned as "rubber stamp bodies" for the controlling parties of the banks. In most cases, the directors failed to establish clear overall policies, to review all loans that were made along with supporting collateral and papers, did not review all cash items and overdrafts at periodic intervals, failed to use reasonable efforts to collect slow assets, to control expenditures properly, did not establish internal routines and controls or conduct the required examinations and in some cases failed to maintain adequate primary and excess fidelity bond coverage. In some cases where sound procedures were provided for, the directors failed to follow-up their directives to see that all were being carried out. In most embezzlement cases, opportunity was offered to the defaulting officers or employees through the failure of bank management to provide adequate safeguards. There have been a number of instances involving collusion between several officers and/or employees in the embezzlement and/or misapplication of funds. In these cases other bank employees were kept from performing key functions and if an employee were to become too inquisitive, he would be immediately dismissed. Characteristic of such cases are long working hours by involved officials or employees and failure to take annual vacations. I will now review a number of banks that have recently closed and relate some of the most significant problems which existed.

The first bank to be discussed was closed in 1970. At suspension, there was a total of $848,000 in certificates of deposit brokered through various money brokers which tied in to about $600 thousand in loans of which $450 thousand were classified loss. There were 1,651 depositors and total deposits amounted to $3,897,000. FDIC was appointed receiver and depositors were paid off to the insured limitation of $20,000. It was interesting to note in this case that the brokered funds were not in the bank on the last regular examination, but came in shortly after the examination concluded. The tie-in loans to firms connected with an individual from a nearby large city and numerous associates were made as brokered funds were received and related principally to an attempt to obtain trucking franchise rights through certain territories. There were also

certain other financial undertakings including the making of a purported "X rated" movie production.

Shortly after the bank closed, the bank president, through his attorney, returned to our representatives a box of blank strange looking instruments called "Irrevocable Letters of Credit" along with numerous files kept at his home. There was also found in the bank's incoming mail funds from individuals, firms and a church along with transmittal forms from the principal broker requesting issuance of Irrevocable Letters of Credit. A quick check disclosed that none of these forms had been issued and that the funds being received after the bank closed represented the initial portion of a $2,000,000 commitment the bank had made to issue these instruments in connection with loans to be made to firms of the same individual whose classified loans led to the bank's closing. The subsequent investigation uncovered facts that sounded like a "fairy tale" with a trail that led from the bank's area to thousands of miles away and back. During these travels, the bank president met with various money brokers among whom was an individual who, on paper, carried impressive credentials and represented himself as a money lender for various wealthy sheiks in Lebanon, and also the principal broker. The agreement entered into between the bank, the borrower, various associates and the money broker called for the bank to issue $2,000,000 in Irrevocable Letters of Credit in multiples of $5,000 each (face amount $5,700 with $700 representing interest to be paid over a two-year term). The funds received from various parties solicited by the broker were to be credited to a demand deposit account in the name of the broker who was to withdraw the funds and disburse them to the borrowers. The Irrevocable Letters of Credit were to be issued to the individuals, firms and churches forwarding the funds <u>but were not to be shown as liabilities on the books of the bank</u>. The notes purportedly to be taken from the borrowers were also not to be shown on the bank's books. Fortunately for the estate of this bank, the funds for the Letters of Credit were received after the bank closed and were returned immediately by our employees. The discovery of this strange instrument, along with information received from the bank president that the broker had told him it was in use in three to four banks in the country, set off an investigative chain of events that intensified with the next closing which will now be discussed.

This next bank was closed two months later after discovery that $2,725,000 in "Irrevocable Letters of Credit" had been issued which were not disclosed on the bank's books. It was further discovered that the funds had been credited to a demand deposit account in the name of the money broker involved. Investigation disclosed that the broker had withdrawn $2,330,000 of these funds and had disbursed portions of them to four "borrowers" with percentages to four money brokers and with other portions being kept for future interest payments and for the broker's "fee." There have been no loan documents found to date evidencing the disbursements to the four borrowers.

It was disclosed that the contract with the broker was concluded after a series of clandestine meetings held in airports and other places with certain "shady individuals." The bank president and the cashier allegedly participated in all of these meetings in an attempt to obtain financing for a local developer, a former school teacher who had dreams of developing a "Sportsmen's City" on vacant land in the area. Other individuals far removed from the bank's area were brought in on the deal as the meetings progressed.

Total deposits of the bank, not including the Letters of Credit, were $9,940,000 and there were 8,068 depositors. The FDIC was appointed receiver and is now involved in extensive litigation to recover funds disbursed by the broker. The bank's directors (excluding the president and cashier) and stockholders are contesting the validity of the Letters of Credit in a court suit and FDIC is precluded from paying deposit insurance on the claims until the litigation which is now on appeal is concluded.

The "letter of credit" scheme set off a chain of events that has led to the closing or "forced merger" of the two banks which were found to have issued non-book letters of credit in more substantial amounts. The third bank fortunately was closed before they could be issued. This scheme is extremely dangerous to operating banks and can wreck a perfectly sound bank in a short time. In this case, funds arrived at the bank and the letters of credit were issued just after the last regular examination was concluded. It took less than two months for the bank to be rendered hopelessly insolvent.

The next bank was closed in mid 1970 because of brokered funds and related out-of-territory and self-serving loans, some of which exceeded the bank's legal lending limits.

Total deposits amounted to $1,257,600 and there were 471 depositors. Brokered funds in the form of certificates of deposit amounted to $722,000 which tied in to $482,400 in adversely classified loans. FDIC was appointed receiver and is now liquidating the bank. An affiliate bank a short distance away had also accepted brokered funds of $498,000 and participated to the extent of an additional $356,500 in the out-of-territory loans. This bank fortunately was able to survive although it experienced some difficulty.

Another bank closed in 1970 after it was discovered that approximately $5,067,000 in non-book Cashier's Checks had been issued by the bank's president to cover losses incurred in the stock market. In addition, a substantial amount of treasury bills held in safekeeping for the bank's customers had been embezzled, other funds had been abstracted and other non-book liabilities had been incurred which increased the aggregate shortage to $6.6 million.

The embezzlement had been going on for about two years and the party involved began dealing in the bank's name using bank funds in an attempt to recoup $10,000 in personal losses in the stock market. He dealt with about 16 stock brokerage firms over a period of the two years, and the shortage was the result of losses incurred in trading and brokerage commissions paid on purchases and sales.

By dealing in the bank's name, the defaulter received stocks in negotiable form (in street names) without making immediate payment. He could hold the securities for a short period of time, hoping to sell them at a profit prior to having to pay for them or he could settle for them by issuing a non-book cashier's check with the hope that he could sell stocks and obtain funds to offset the cashier's checks when they were deducted from the bank's account at the Federal Reserve Bank. There were periods when profits were made, however, the long run result was losses and as the loss began to snowball, the additional scheme of returning non-book cashier's checks previously issued as a part of the outgoing cash letters was utilized to obtain an additional period of float. Some of these checks were returned through a correspondent several times and, apparently because of the automated handling of checks, this was not detected until just prior to the closing of the bank.

Total deposits amounted to $15,913,000 and there were 9,600 depositors. FDIC was appointed receiver and is now liquidating the bank's assets.

The next closing was due to self-serving loans made by the bank's president to firms controlled by him. The total amount of these self-serving loans was about $1,000,000, and in some cases the loans were in different names from the firms which received the loan proceeds. In addition, the bank's president charged excessive personal expense items against the bank's expense account. There were also generally poor loans made to local individuals and firms and collections in general were lax.

Total deposits amounted to $7,198,000 and there were 5,778 depositors. FDIC purchased the unacceptable assets and the deposit liability was assumed by a newly organized bank.

The next bank was closed because of unsafe and unsound loan practices and classifications which created an impairment of deposits. Total deposits amounted to $8,829,000 and there were 1,940 depositors. Total uninsured deposits amounted to $2,900,000. There were $510,000 in brokered funds which tied in to loans in the original amounts of approximately $500,000. In addition, various other funds amounting to approximately $6,385,000 were on deposit and for all practical purposes these functioned as "hot money," that is, they tied in to loans made by the bank to a principal borrower.

Based on a premium payment to FDIC of $400,000, assistance was feasible and the deposit liabilities were assumed by another bank and FDIC is liquidating the bank's assets which were purchased for cash by FDIC.

The next closing was due to nonconforming loans in excess of the legal lending limit and out-of-area loans of questionable quality. A majority of these loans were self-serving loans to companies of the controlling stockholder. There were also loans made to some of the same firms and individuals which were indebted to another bank which closed 4 months earlier. Loan classifications amounted to $432,200 Loss, $150,500 Doubtful and $153,273 Substandard and after deduction of Loss and 50% of Doubtful, Capital and Reserves were exhausted leaving a deposit exposure of $128,500.

Total deposits amounted to $5,420,300 and there were 3,312 depositors. There were 14 uninsured depositors having an excess of approximately $200,000 on deposit over the $20,000 insured limitation.

FDIC purchased all of the bank's assets except the banking house and furniture, fixtures, and equipment. The deposit liabilities were assumed by a newly organized bank based on a premium paid of $50,000 on deposits and a bid of $80,000 for the fixed assets.

Closure of the next bank came after the bank had experienced a runoff of about $15 million in deposits caused from unfavorable publicity in connection with a SEC action against the bank, its principal owner, his corporate interests and others. Total deposits were $66,771,364.71 which included brokered funds of $31,661,623.73, and there were 27,300 depositors. Insured deposits amounted to about $50 million.

This closing represented the largest payoff ever made by the Corporation since its inception in 1934, and payments to depositors began within seven days after closing. We were staffed to pay depositors at the rate of 400 per hour, however, the rate of payments only reached this point during the first day and at given peaks during the first several days. The Corporation was appointed receiver and is in the process of liquidating the bank's $81.7 million in assets. This is a tangled matter and we are involved in extensive litigation.

The underlying cause of the closing was misuse of brokered funds for self-serving loans of very poor quality to the principal officer, his interests and various associates. Coupled with this were liberal loan policies, ineffective collection practices, poor diversification of assets, liquidity problems, unsound investment policies, etc.

The next bank with assets of $113.4 million, deposits of $57.7 million, and borrowings of approximately $40 million was closed in early 1971. Bids were taken and FDIC subsequently entered into an assistance transaction with the successful bidder, a newly-formed bank which assumed the deposit liabilities and opened for business five days later. This transaction took place over a holiday weekend and there was no interruption of banking service. The Corporation disbursed $103.4 million as a loan to itself as receiver to consummate the transaction. The loan was collateralled by all assets of the closed bank which the Corporation is now in the process of liquidating.

The immediate cause of closing was a result of a refusal to permit renewal of approximately $40 million in borrowings through another bank which had been outstanding for a considerable period of time without a retirement program. The underlying causes of insolvency were securities depreciation of a substantial amount in long-term municipal securities, hazardous lending, credit and collection policies, adversely classified self-serving loans to the controlling element, forward loan commitments and unwarranted payments of cash dividends based on unrealized and contingent future income tax benefits.

There were 1101 depositors with total deposits of $2.077 million in the next small bank which closed after a shortage of approximately $500,000 was discovered.

FDIC was appointed receiver and depositors were paid off to the insured limitation. A newly-organized bank opened for business in the banking quarters on February 22, 1971, when the payoff of depositors began.

The shortage was created by various manipulations of cash, deposit accounts, a correspondent bank account and forged, fictitious and fraudulent loan documents. In addition, loan loss classifications amounted to $210,700 involving principally self-dealing loans made to the bank's president and his interests.

The next closing involved a small bank with 416 depositors and total deposits of approximately $606,000 which was declared insolvent by the State Authority on April 2, 1971. The State Authority took possession of the bank following a routine examination which disclosed that the bank had been sold without notification to the Supervisory Authorities to out of State individuals and that serious irregularities existed. The Declaration of Insolvency came after investigation disclosed that the former executive officer had embezzled approximately $20,000, which had been restored, and loan loss classifications involving principally the former and new owners amounted to $77,457 which exhausted the capital structure. Brokered funds totaling $80,000 were placed in the bank shortly after the new owners purchased control, and these apparently relate to $45,000 in loss classification loans to the new purchasers which were made just after the change of management.

The Corporation began the payment of insured deposits on April 7, 1971, just one day after our payoff crew arrived at the bank site. The State is liquidating the bank's assets.

The next bank with book deposits of approximately $1,200,000 was closed on November 30, 1971 following the discovery of a large shortage shortly after the deaths of the bank's vice president and cashier in April 1971. Local officials ruled that the deaths were the result of "an agreement of mutual self-destruction." Both had been shot in the head and their bodies were found in a field on a ranch about 15 miles northwest of the bank's location.

We are still trying to unravel the complicated affairs of this bank and many long hard hours lie ahead of our field staff. As of this time, the overall shortage is estimated at approximately $800,000 and virtually every method of internal manipulation seems to have occurred. We have detected withheld deposits, pulled ledger sheets, false debits and credits, withheld note payments, loans made to non-depositors directly from depositors' accounts without notes being signed, withheld checks and other miscellaneous manipulations.

Insured deposits are still being paid and shortages are being traced and accounts reconstructed. Characteristic of this bank's operation were inadequate records, poor housekeeping and unbelievable internal procedures. An example of this is the fact that the bank at times did not post its daily work for two weeks. The daily journal never balanced and statements were not sent on most checking accounts unless a depositor protested.

The last case to be discussed involves a bank which was closed because of self-serving loans of a dubious nature to the bank's management and adversely classified out-of-territory student loans which tied into brokered funds.

This bank, which was organized in 1964, had suffered from its inception because of disputes between two factions on the Board which together held the controlling interest. In 1970, a local farmer and businessman purchased control. This individual had no prior banking experience and the chief operating officer whom he appointed was apparently not capable of managing the bank properly. The new owner, through a corporation he organized, brought in discounted Student Loans, and through a money broker, acquired brokered funds which tied into these loans. The adverse classification of these loans, which were not Federally insured as represented, and of self-serving loans to a former director exhausted the capital structure and created a deposit exposure.

Total deposits were $3,488,500 and there were 1,961 depositors which included approximately $325,000 in brokered funds. We began the payoff of depositors and the State is liquidating the bank's assets.

It is unreasonable to expect that bank failures will ever be eliminated. At the same time, the Corporation is dedicated to improving the standards of safety in banks so that losses to depositors and the economy can be minimized. For the millions of bank customers using checking accounts, savings accounts, and other services, it is hoped that the seal of this Corporation will always be a symbol of confidence.

RESPONSIBILITIES OF A BANK DIRECTOR

Most of you are aware of the safeguards suggested by various banking organizations for establishing a successful loss prevention program in banks. Being a part of the Liquidation Division of the Federal Deposit Insurance Corporation, we have become quite aware of where bank losses are likely to occur and the importance of a loss prevention program in every bank. As bank liquidators, we are very often faced with the question of what responsibilities a bank director has for preventing losses. To be elected a director of a commercial bank means that you have been elected to a position of honor, but it does carry with it certain legal responsibilities.

As bankers, you know the value of maintaining a variety of internal controls and the use of outside audit firms and you are aware of the importance of direct verification of accounts with customers and correspondent banks. You also know the prime requisites for maintaining a sound loan policy and establishing a profitable but secure investment program. Recently, we have all become aware of the hazards of brokered deposits when these funds are used in making unsafe or self-serving loans.

To place a director's responsibility in perspective as far as closed banks are concerned, I would like to summarize briefly the role of the Federal Deposit Insurance Corporation in bank failures.

The publicity involving the Sharpstown State Bank failure in January of 1971, the Birmingham Bloomfield failure in February of 1971, and the recent bank failure in Wakefield, Massachusetts, has made the public aware of two important activities of FDIC, the payment of deposit insurance, and liquidation of assets of closed banks when appointed receiver. Both of these activities are carried on by the Division of Liquidation of the Federal Deposit Insurance Corporation.

Historically, banks close in good times and bad and there have been no banks closed in recent times which were due principally to factors related to the economy. In about a quarter of the banks which have closed since 1934, defalcation or to use another term, embezzlements, have been the direct cause of the closings.

As to the remaining three-quarters, if we exclude those failures in our early years which were carry-overs from the Great Depression, the causes of closing range from poor judgment in making loans coupled in some cases with lax collection policies to circumstances bordering on outright fraud. The fraudulent practices leading to some of the closings occurred both from inside and outside of the bank.

When an insured bank is closed by its chartering authority, which is the Comptroller of the Currency in the case of national banks or the appropriate State Authority in the case of State banks, the Corporation dispatches representatives immediately to the closed bank site who begin immediate preparations to provide for return of the depositors' funds at the earliest possible time.

The Corporation is appointed receiver in all closed national banks and serves in that capacity in state banks where so appointed. When the Corporation has been appointed receiver, which it is in the majority of cases, liquidators are also dispatched to the scene immediately.

The FDIC has two basic alternatives to protect depositors when an insured bank has been closed:

1. It may pay off depositors up to the insured limit of $20,000.

2. It may assist another sound insured bank in the community to assume the deposit liabilities of the closed bank by purchasing for cash or making loans secured by certain assets of the closed bank. The assets purchased or securing the loan made by the Corporation are generally those which could not be held by the assuming bank. In order for the Corporation to enter into an assumption transaction, there must be a bank willing to assume the deposit liabilities of a distressed bank which is acceptable to the chartering Authority, and it must be established that this method is cheaper to the Corporation than a payoff of depositors before assistance of this type can be rendered.

To give you some idea as to the frequency of failures, there have been 496 insured banks closed during the period January 1, 1934 to date. Of this number, 294 have been payoff cases, and 202 were deposit assumption cases, where the

Corporation either purchased assets or made a loan. There were 1,796M depositors in the 496 banks with total deposits amounting to $1,083,202,000.

Total disbursements and recoveries from 1934 to December 31, 1971 were:

Disbursements	$ 685,755,000
Recoveries	610,105,000
Losses	$ 75,650,000

Recoveries to depositors for this same period were:

% depositors receiving full recovery (number)	99.4%
% depositors receiving full recovery (amount)	97.1%

The Division of Liquidation is now handling 57 open liquidation cases (Receiverships - 26; AP or L - 31). Of these, 20 are handled from the Washington Office and 37 are handled from 30 field liquidation offices. The Division has 270 employees involved in the liquidation of these banks of which 74 are permanent employees subject to nationwide travel on short notice and 196 are temporary employees who live in the area of the closed banks and assist our permanent staff.

As of June 30, 1972, there were 28,000 assets in the open liquidation cases having a remaining value of $250 million to be liquidated. As previously stated, of the 496 closings to date, 202 were assumption cases.

After an insured bank has been closed by either the State Banking Authority or the Comptroller of the Currency, the Federal Deposit Insurance Corporation, because of the fiduciary duties imposed upon it in its capacity as receiver of the closed institution, must of necessity consider whether any legal liability has been incurred by the directors of the particular bank.

When a bank director takes his oath of office he swears he will do his best to manage his bank in such a way that the statutory law applicable to it will not be violated. It is, therefore, important that the director become familiar with the statutes applicable to his particular bank, and not violate them. If he conducts the affairs of his bank within the statutory framework, heeds all warnings that may come to him from whatever source concerning things that may be going wrong in the bank by making the proper checkup in connection with any warnings from bank examiners, the State Banking Authority, or anyone else, and

if a director does not abandon his duties and functions, the chances are extremely remote that he will find himself a defendant in a directors' liability suit. If nothing else is remembered from my remarks, remember these three phrases:

(1) A director should make sure the bank abides by the statutes applicable to it;

(2) He should not abandon his very important duties and functions; and

(3) He should heed any warnings he may receive as to any improprieties that may or may not be occurring in connection with the bank's operations.

In general, the directors and other corporate officers of a bank may be held personally liable for

(1) a breach of trust,

(2) negligence, the proximate cause of losses,

(3) acts in excess of their powers,

(4) fraud, and

(5) misappropriation or conversion of the bank's assets.

The liability of directors and other officers of a bank is determined substantially by the same principles which determine liability of any agent to a principal for failure to perform his duties. From the standpoint of imposing directors' liability in the case of a closed bank where the facts are such that fraud, misappropriation, conversion, or breach of trust may be clearly shown, a relatively simple situation presents itself where it is obvious to everyone that liability exists. The difficulties usually arise in cases involving negligence which falls short of breach of trust or fraud. While the applicable principles in these cases are easy enough to state, their application to factual situations presents difficulties, in that courts from time to time, after stating the principles, have either found liability or no liability, with no real criterion set out for the difference in the result.

There are generally two bases of liability of a director, one for failure to exercise that degree of care which ordinarily diligent and prudent men would exercise under the circumstances, and one which provides that directors who shall knowingly violate, or knowingly permit any of the officers or agents of

the bank to violate any of the provisions of banking regulations, shall be personally liable for all damages which the bank, its shareholders, or any other person shall have sustained as a result of such violation.

An example of a breach of official duty is when a president and director of a bank causes his bank to accept and approve the notes of his son, which otherwise would not have been accepted, through his assurances to other officers of the bank that he personally would be responsible for the indebtedness in question. The directors of a bank are guilty of a plain breach of duty if they retain in a responsible position a man who has shown himself to be unworthy of trust.

It is well settled that bank directors or other officers may render themselves personally liable for negligence in the making of loans which result in loss to the Corporation, and this liability may result either from making of the loan, from renewing it, or in failing to collect it, if they are guilty of any want of ordinary care in the making of loans on behalf of the bank which causes it loss. They are, of course, liable where they have either wilfully or negligently made bad loans resulting in loss to the Corporation.

If directors of a bank make loans to persons known to be insolvent, the directors are liable to the bank for the loss. Directors of a bank who own a majority of the capital stock can be held liable if they permit improvident and excessive loans to be made by the bank officers to the original directors themselves and their interests, causing the bank to become insolvent.

There have been cases where officials of a bank permitted large overdrafts by a corporation known to be financially embarrassed, and they were held liable by the court for the amount so lost.

When reviewing directors' liability, it is essential that consideration be given to negligence of directors. It perhaps would be most helpful to you to have a brief review of particular acts with respect to whether or not they constitute negligence. The following are some examples:

(1) A president who has willingly, by culpable negligence, received forged municipal bonds is personally liable for the loss.

(2) Acceptance by the president, a director of the bank, of doubtful securities in payment of good debts is negligence.

(3) Authorization for the purchase of a large amount of commercial paper affected with a patent infirmity, creates liability.

(4) The directors of banks are negligent and liable when they fail to heed the warning of the Bank Commissioner.

(5) Directors have been held clearly negligent in failing to hold meetings, as required by the bylaws of the bank, and failing to obtain a statement of the financial condition of the bank.

(6) Directors have been held negligent and liable for refusing or omitting to proceed against their predecessors in office to recover losses sustained by the latter's negligence.

(7) Bank directors have been held guilty of negligence in paying dividends when the capital had been impaired and when reserves were deficient.

(8) It has been held that a director who never makes, or causes to be made, any examination whatever of the books and papers of the bank to determine its condition and the way in which it is being conducted, does not exercise ordinary care and prudence in the management of the bank and cannot be shielded from liability because of his alleged want of knowledge of wrongdoing, as his ignorance was the result of gross inattention in the discharge of his voluntary and sworn duty.

(9) Bank directors have been held negligent for failure to appoint a committee to audit the affairs of the bank, and for relying on the integrity of the president of the bank without causing an examination to be made of the bank's books and papers.

(10) The mere failure of a director to attend a specific meeting of the board is not necessarily negligence. On the other hand, it is not open to doubt, that a wilful and continued failure on the part of a director to attend meetings of the board at which the business of the bank is conducted, and to familiarize himself, to some extent, with the bank's affairs, is a violation of the duty which the common law imposes upon directors and, if loss results therefrom, that he is liable, because such action is, in itself, a failure to exercise the ordinary care and prudence in the administration of affairs of the bank which the law imposes upon directors.

Considering the numerous duties with which a bank director is charged and the penalties for their neglect, it may seem strange that enough public-spirited individuals can be found in a community to undertake the job when considering that the remuneration is relatively nominal. The answer to this is that the director who exercises reasonable and ordinary care does not expose himself to the penalties of the law. This does not mean that the board of directors can safely rely on the bank's officers and the reports of the bank examiners of the Comptroller, Federal Reserve Board, FDIC, or state authorities. For the board of directors and its committees to do their duty with reasonable care requires more than just regular attendance at meetings. Much careful work must be done by or for the board. Here let me emphasize that we do not assert a claim for directors' liability because of the failure of the directors to uncover an embezzlement or a misapplication of funds. The claim for directors' liability is asserted when the directors fail to perform the functions which are required by law or under the bylaws of the particular bank.

In our efforts to determine whether a claim exists against the directors in a closed bank we examine the following:

1. The functioning of the examination committee during the decade preceding the closing of the bank.

2. The pertinent bylaw provisions governing the duties of such committees.
3. The dates of its meetings showing their regularity.
4. The extent to which its reports were referred to and considered by the board, like information on the loan and discount committee.
5. The regularity with which board meetings were held and the pattern of attendance at those meetings and the nature of the business acted upon thereat as reflecting the degree of attention being given to the affairs of the bank.
6. The extent to which the board considered and acted upon correspondence from, and reports of examination by, the supervisory authorities, particularly where criticisms are contained in those communications.
7. The extent to which there were red flags or irregularities, that is, abnormal fluctuations in savings and checking account totals, in the volume and nature of the loan portfolio.
8. In the amount of holdings of U. S. and other public securities and in the totals of correspondent bank balances, all as shown by the records and books of the bank.
9. Any knowledge of irregular acts on the part of officers and employees and action taken as a result of such knowledge. Many other areas, such as notoriety in high living on the part of relatively low-salaried officers, normally are sifted with care to see whether a directors' liability action is justified.

In a bank, the director's duty is to direct and not to be led. The officers are charged with carrying out the director's policies, but it is not enough for the directors to lay down the policies. They must be ever alert to insure that the policies are being faithfully, ably, and honestly executed by bank personnel.

While it may be distasteful at times to assert a director's liability claim, it is mandatory that a liquidator do so if the basis for a claim is discovered. The supervisory authorities must accept their responsibilities and the officers of banks, as well as directors, must also assume their responsibilities if our system of banking is to survive and prosper.

If a director always remembers he is a manager of other people's money, he is ready to accept the responsibilities of being a director.

The two primary purposes of the Congress in creating the Federal Deposit Insurance Corporation -- to protect depositors in closed banks and to promote a sound and viable banking system which merits public confidence -- remain the objective of the Corporation. The challenge of these tasks is sharpened by the continuing growth in size and complexity of the nation's economy and banking system.

It is unreasonable to expect that bank failures will ever be eliminated. At the same time, the Corporation is dedicated to improving the standards of safety in banks so that losses to depositors and the economy can be minimized. For the millions of bank customers using checking accounts, savings accounts, and other services, it is hoped that the seal of this Corporation will always be a symbol of confidence.