FEDERAL RESERVE BANK
OF DALLAS

DALLAS, TEXAS
75265-5906

July 31, 2002

Notice 02-38

TO: The Chief Executive Officer of each
financial institution and others concerned
in the Eleventh Federal Reserve District

SUBJECT

Guidance Regarding Indemnification Agreements and Payments

DETAILS

The Board of Governors has issued guidance regarding indemnification agreements and payments. The guidance reminds Reserve Bank examination and applications staff, state member banks, and bank holding companies of the limitations on indemnification imposed by section 18(k) of the Federal Deposit Insurance Act, which was added by the Crime Control Act of 1990 and the regulations issued by the FDIC.

ATTACHMENT

The Board's guidance is attached.

MORE INFORMATION

For more information, please contact Gayle Teague, Banking Supervision Department, at (214) 922-6151. Paper copies of this notice or previous Federal Reserve Bank notices can be printed from our web site at **http://www.dallasfed.org/banking/notices/index.html**.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 02-17
July 8, 2002

TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE SUPERVISORY AND EXAMINATION STAFF AT EACH FEDERAL RESERVE BANK AND TO BANKING ORGANIZATIONS SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: Guidance Regarding Indemnification Agreements and Payments

Recently, some merger and acquisition applications filed with the Federal Reserve have included broad scope indemnification clauses in the agreements between the parties to the proposed transactions. Some of these indemnification clauses seek to indemnify the target financial institution's officers, directors, and employees from any judgments, fines, claims or settlements whether civil, criminal, or administrative that relate to "conduct before the merger or acquisition." Some state member banks and bank holding companies have also adopted broadly worded indemnification provisions in their by-laws or entered into separate indemnification agreements that cover the on-going activities of their own institution-affiliated parties.[1] Federal Reserve staff has found that many of the indemnification provisions are inconsistent with federal banking law and regulations, as well as safe and sound banking practices, and has advised applicants and supervised institutions about the deficiencies.

The purpose of this letter is to remind Reserve Bank examination and applications staff, and state member banks and bank holding companies of the limitations on indemnification imposed by section 18(k) of the Federal Deposit Insurance Act, which was added by the Crime Control Act of 1990, and the regulations issued thereunder by the FDIC. The law and regulations apply to indemnification agreements and payments made by any bank or bank holding company to any institution-affiliated party, regardless of the condition of the financial institution. The purposes of the law and regulations are to preserve the deterrent effects of administrative enforcement actions by ensuring that individuals subject to final enforcement actions bear the costs of any judgments, fines, and associated legal expenses, and to safeguard the assets of financial institutions.

The FDIC's regulations define a "prohibited indemnification payment" to include any payment or agreement to make a payment by a bank or a bank holding company to an institution-affiliated party to pay or reimburse such person for any liability or legal expense in any administrative proceeding brought by the appropriate federal banking agency that results in a final order or settlement in which the institution-affiliated party is assessed a civil money penalty, is removed or prohibited from banking, or is required to cease an action or take any affirmative action, including making restitution, with respect to the bank or bank holding company.[2] Under the

FDIC's regulations, a bank or bank holding company may make a reasonable payment to purchase commercial insurance to cover certain costs that the institution incurs under an indemnification agreement. Costs that may be covered by insurance include legal expenses and restitution that an individual may be ordered to make to the institution or receiver. The insurance may not, however, pay or reimburse an institution-affiliated party for any final judgment or civil money penalty assessed against such individual.

The FDIC's regulations provide criteria for making permissible indemnification payments. A bank or a bank holding company may make or agree to make a reasonable indemnification payment if all of the following conditions are met: (i) the institution's board of directors determines in writing that the institution-affiliated party acted in good faith and the best interests of the institution; (ii) the board of directors determines that the payment will not materially affect the institution's safety and soundness; (iii) the payment does not fall within the definition of a prohibited indemnification payment; and (iv) the institution-affiliated party agrees in writing to reimburse the institution, to the extent not covered by permissible insurance, for payments made in the event that the administrative action results in a final order or settlement in which the institution-affiliated party is assessed a civil money penalty, is removed or prohibited from banking, or is required, under a final order, to cease an action or take any affirmative action.

The law and FDIC's regulations, which apply to all state member banks and bank holding companies, reinforce the Federal Reserve's longstanding policy that an institution-affiliated party who engages in misconduct should not be insulated from the consequences of his or her misconduct. From a safety and soundness perspective, a state member bank or bank holding company should not divert its assets to pay a fine or other final judgment issued against an institution-affiliated party for misconduct that presumably violates the institution's policy of compliance with applicable law, especially in cases where the individual's misconduct has already harmed the institution. Although state corporate laws may allow a company to adopt by-laws indemnifying its institution-affiliated parties, any indemnification provisions or agreements adopted by a state member bank or bank holding company must comply with federal law and the FDIC's regulations concerning indemnification.

In addition, bank holding companies that issue securities to the public under a prospectus declared effective by the U.S. Securities and Exchange Commission should note that the SEC's Regulation S-K (17 CFR 229.512) requires that the prospectus include the following statement: *Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers, or persons controlling the registrant, the registrant has been informed that in the opinion of the SEC such indemnification is against public policy as expressed in the Act and is therefore unenforceable.*

State member banks and bank holding companies should review their by-laws and any outstanding indemnification agreements, as well as insurance policies, to ensure that they conform with the requirements of federal law and regulations. In the event that a state member bank or bank holding company fails to take appropriate action to bring its indemnification provisions into compliance with federal laws and regulations, appropriate follow-up supervisory action may be taken. Applications involving banks or bank holding companies with indemnification-related

issues identified in the supervisory process will be reviewed by Federal Reserve staff for compliance with federal law and regulations.

Reserve Banks are asked to distribute this letter to all state member banks and bank holding companies in their districts, as well as their examination and applications staff. Should you have any questions regarding this matter, please contact Nancy Oakes, Counsel, Division of Banking Supervisions and Regulation, at (202) 452-2743.

Richard Spillenkothen
Director

Note:

1. The term “institution-affiliated party” includes any officer, director, employee, and controlling stockholder, as well as others who participate in the affairs of a financial institution. The term is defined in the law at 12 U.S.C. 1813(u).

2. Refer to 12 CFR Part 359.