

BANK DIRECTORS RESPONSIBILITIES

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**BUREAU OF FINANCIAL INSTITUTIONS
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INTRODUCTION

This booklet does not purport to be all-inclusive, but rather presents a brief commentary on the duties and responsibilities of directors of state banks in the Commonwealth of Virginia. Part I of the booklet emphasizes what the Bureau of Financial Institutions of the State Corporation Commission perceives the role of a bank's board of directors to be and the minimum standards of conduct under which such a board should function. Part II presents a summary of the provisions of the Virginia Code which deal with or affect bank directors.* Part III provides some reference material on the subject matter which the Bureau believes present and future bank directors will find useful and rewarding.

There may be situations in which individual bank directors or boards of directors are uncertain of their powers, duties and liabilities. When they occur, directors or boards are encouraged to submit their questions to the bank's counsel and/or the appropriate regulatory authorities.

*Important Note: Part II is a summary only of the laws which deal most directly with bank directors. Other laws and regulations also affect the conduct of a financial institution's business by its officers and directors. The information in Part II is not intended as legal advice; such information is not — nor could it be to any appreciable degree — a substitute for the continuing advice of competent legal counsel retained for the purposes of assisting the board as it conducts the affairs of the bank.

PART I

DIRECTION

The board of directors of every bank is charged with absolute responsibility for directing the bank's affairs. In discharging this responsibility, however, the board is not expected to involve itself in actual, direct supervision of the daily routine operation of the bank; that is the function and responsibility of management. Directing means providing the bank's operating management with a clear and concise set of guidelines and policies which will serve as the framework within which the bank's affairs should be conducted, limited, or controlled. But it means more — it also means that the board needs to establish a mechanism for overseeing the performance of management in such a way as to ensure that its policies and guidelines are being executed effectively. Such guidelines and policies should cover all major functions, including (but not necessarily limited to) market strategy, management of resources, lending, investments, personnel, and conflicts of interest. In addition, policies and guidelines should be reviewed periodically for effectiveness and possible revisions or updating. They should be reaffirmed at least annually and that action noted in the board's minutes.

MANAGEMENT

It is the responsibility of the board to provide competent and capable management and to assure effective continuity of management. The board should select a chief executive officer who is qualified in all respects to meet the particular objectives of the bank and who can and will lead the bank toward fulfilling its goals. Obvious qualities to look for are: a suitable background and adequate training, a strong, well documented record of accomplishment in banking at a comparable level, a capacity for leadership, familiarity with the current banking environment, analytical ability, and a realistic outlook. It should be made clear to management that its responsibility is to manage in accordance with the board's policy. The board should not abdicate its responsibility for directing the affairs of the bank and become a "rubber stamp," i.e., simply approve the actions of management without question or reason. At the same time, management should realize that it has a responsibility to inform the board if unsound or unsafe policies or improprieties appear to exist.

COMPOSITION

Chapter 8 of Title 6.2 of the Code of Virginia states that the board of directors must consist of not less than five persons. It should be noted in this connection that large boards, especially in newly-organized banks, frequently tend to be unwieldy and ineffective. A board of a new bank has been observed to be most effective when membership ranges from seven to eleven persons.

Because a bank is organized to serve the needs of a particular community, board members should reside or work within that community or have some substantial interest there. Broad representation of various interests in a community is essential; a cross-section will often include minority-group members and civic leaders as well as representatives of business and professional interests which provide support for the community's economy. A diversified board benefits the bank by incorporating different, valuable talents and expertise, offering varied viewpoints on issues, and affording a broad base of support.

STOCK OWNERSHIP

Chapter 8 of Title 6.2 of the Code of Virginia requires bank directors to be stockholders of the bank or its ultimate parent. This requirement is based on the premise that one whose investment is at stake has an incentive to work hard and conscientiously.

On the other hand, experience has shown that sometimes a major stockholder will attempt to dominate the board. This situation should be avoided in the best interests of the bank and its stockholders. Because a bank is organized to serve the needs of the community, stock should be widely distributed, with no single director or stockholder owning more than five percent of total capital directly or ten percent indirectly (through family or business interests). Widespread distribution reduces the probability of domination by one or more large stockholders.

MEETINGS

All directors are expected to attend board meetings regularly. Those who fail to attend meetings cannot relieve themselves of accountability for board actions by pleading ignorance of transactions in which they did not participate. In addition, directors should actively participate in various committees to which they may be assigned. Such committees may have delegated authority of the board to act within specified limits, but ultimate responsibility for committee actions remains with the board, to which the committees report.

COMPLIANCE

To maintain the integrity of the bank and a safe and sound banking environment, it is the responsibility of the board to assure that banking laws, regulations, and the directives of regulatory authorities are strictly observed. The board is responsible for reviewing all reports of examination and all audits performed by outside sources, and for causing any changes to be made which are necessary to correct the deficiencies contained in these reports. The minutes of board meetings should reflect such review and cite the actions taken by the board.

EXAMINATIONS AND AUDITS DISTINGUISHED

Section 6.2-898 of the Virginia Code provides that the State Corporation Commission shall at least once in every three-year period and at such other times as it may deem necessary cause to be examined every state-chartered bank. A copy of the report of each examination is forwarded to the board of directors of the bank examined for review. Such review should be reflected in the minutes of the board of directors.

It cannot be emphasized too strongly that a supervisory examination is not an audit of the institution. It should be understood that the primary function of an examination is to determine whether an institution is solvent and sound in all respects and is being directed and managed in such a way as to provide reasonable assurance of its survival. The chief duties of an examiner are to ascertain that the requirements of statutes and regulations are being complied with, analyze the institution's condition and evaluate its performance, determine whether policies and procedures conducive to soundness and profitable operation are being followed, and suggest remedies for deficiencies in any of these (or other) categories of concern.

Some directors and executives erroneously believe that regular examinations by supervisory authorities are conducted for the purpose of detecting embezzlement or other dishonest activity. Although in some instances fraud has been discovered during the course of a supervisory examination, detecting dishonesty is not a primary purpose of an examination. An examination is concerned with a bank's financial condition, its compliance with the various laws and regulations and the soundness of its operating policies; it cannot be relied on to detect fraud and embezzlement. Examinations are not audits. There is no substitute for an adequate program of internal controls and audits, in conjunction with professional independent audits, in providing reasonable protection for a bank against internal defalcation or fraud.

INTERNAL CONTROLS

The most effective method of preventing and detecting fraud is an adequate system of internal controls. Internal controls are put in an accounting system to safeguard the assets of the organization, check the accuracy and reliability of its accounting data, promote operating efficiency, and encourage adherence to prescribed managerial policies. An adequate system of internal controls tends to prevent defalcation by reducing the opportunity, and therefore the temptation, to misuse the bank's assets. Descriptions and models of internal control systems (indeed, procedures covering all aspects of bank operations) are available from several sources, including professional and trade organizations, as well as from other banks.

CONFIDENTIALITY AND CONFLICTS OF INTEREST

Sensitive matters discussed at board meetings and information gained in the course of doing the bank's business may not be divulged or used for personal gain. It is essential for the board to guard against insider abuse, such as permitting preferential interest rates or more favorable terms and conditions in granting credit to directors and their interests than in offering credit to customers generally. All transactions between a bank and its board members or their interests require careful scrutiny, since even the appearance of impropriety must be avoided.

RESPONSIBILITIES AND LIABILITIES OF DIRECTORS

Bank directors are ultimately responsible, in a fiduciary sense, for whatever the bank does, including its acquisition and use of resources, the adequacy of its net worth, the soundness of its assets, its ability to meet all obligations, and its ability to earn enough profit to survive and prosper. How well these responsibilities are fulfilled is directly related to, and dependent upon, the quality and adequacy of management. However, directors are expected to exercise general supervision over the affairs of the bank, and the board cannot escape this obligation by attempting to delegate it to the managing officers. Therefore, each director should give personal attention to reports of examination and letters from supervisory officials. Directors should likewise give personal attention to the content of the bank's statements of condition published and furnished to supervisory officials.

It has been previously pointed out that board members are expected to attend meetings of the board, and that those who fail to attend are not thereby

relieved of accountability for board actions. Moreover, resignation from the board does not necessarily remove the potential for liability arising from action taken as a director. Directors may be subject to personal liability to shareholders if their negligence or their intentional acts result in harm to the bank. Courts have held directors liable for willful misconduct, breach of trust, or gross negligence, but ordinarily not for honest mistakes of judgment. If directors fail to use proper prudence and diligence, and a loss to the bank results, they may be held personally liable for the amount of the loss in a civil action for damages. In such a case, each director may be sued alone or jointly with other directors.

PART II

SUMMARY OF VIRGINIA LAWS AFFECTING BANK DIRECTORS

Number of Directors: Section 6.2-860 of the Virginia Code requires all banks incorporated under the laws of Virginia to be managed by a board of directors consisting of not less than five persons.

Directors Must Be Stockholders: Every director of a bank incorporated under the laws of Virginia must also be a stockholder of the bank or its ultimate parent. Each director must have in his personal possession or control shares of stock in the bank having a book value of not less than \$5,000, calculated as of the last business day of the calendar year immediately preceding the election of the director. So long as a director shall successively be reelected, there is no requirement to increase the number of shares owned, according to Section 6.2-862. Such qualifying stock must be registered in the director's sole name (not jointly with anyone, including a spouse) and must be unpledged and unencumbered (not hypothecated as security for a loan) at the time the director assumes his office and during the whole of his term. The same section specifies that when a bank is controlled by a bank holding company, a director may comply with the provisions of the law by owning capital stock of the bank holding company having an aggregate book value equal to the book value of shares of stock that would be necessary under the preceding provisions.

Board Meetings: Section 6.2-866 of the Virginia Code requires the board of directors of every bank to hold an official meeting at least once in each calendar month, unless the Commission allows less frequent meetings. In any event the board must meet quarterly. The presence at the meeting of a majority of the board is necessary for the transaction of business, except that the bank's bylaws may provide that any number not less than five constitute a quorum.

Moral Fitness, Financial Responsibility, Etc.: Section 6.2-816 states that before issuing a certificate to begin a banking business the Commission shall ascertain (among other things) that the moral fitness, financial responsibility, and business qualifications of those named as officers and directors of the

proposed bank are such as to command the confidence of the community in which the bank is proposed to be located.

Information on Newly-Elected Directors: Within sixty days following the initial election of any person as a director of a bank, the bank must report that election to the Commission and furnish such information relative to the new director's personal character, integrity, financial condition, and personal and business background as the Commission may prescribe. The report shall be signed by the new director as well as a designated officer of the bank. (Section 6.2-864).

Oaths of Directors: Section 6.2-863 requires every bank director, within thirty days after being elected, to take an oath that he will diligently and honestly perform the director's duties and that all the requirements of stock ownership, as indicated above, have been met. Such oath, subscribed to by the director and certified by the officer before whom it is taken, shall be transmitted by the cashier of the bank to the Commission. Any director who fails for a period of thirty days after election or appointment to take the oath as required shall automatically forfeit the office.

Directors to Serve Only One Institution: Section 6.2-104 of the Virginia Code prohibits officers and directors from serving more than one financial institution (excluding consumer finance companies and credit unions domiciled in Virginia), unless the institutions belong to the same holding company. However, upon petition brought on behalf of an individual, the Commission may permit him to serve two institutions, if it is found that the financial institutions are not in competition with each other, or that one or both of the institutions might otherwise be denied capable management or direction from an individual residing in or employed in the locality served by an institution.

Bonds of Officers and Employees: The board of directors of every bank must require bonds from all active officials and employees. Section 6.2-868 of the Virginia Code states that, in lieu of individual bonds, the board may obtain a blanket bond covering all officers. The surety on every bond shall be a bonding or surety company authorized to transact business in Virginia, and the penalty of any such bond shall be increased whenever, in the opinion of the Commission, it is necessary for the protection of the public interest.

Joint Control of Subscription Money and Bonding Requirements: Section 6.2-817 requires all money received for subscriptions to or purchases of stock of a bank in organization to be deposited in an escrow account in insured

financial institutions or invested in United States government obligations, under the control of two organizing directors. Both organizing directors must be bonded for an amount equal to the total amount of money to be collected. Both subscription money and any income earned should be remitted to the bank on the day it opens for business. In the event the bank is denied a certificate of authority or is refused insurance of accounts, or if it otherwise is determined that the bank will not open for business, such funds, after payment of any amount owing for organizational expenses, must be refunded to subscribers or shareholders.

Loans to Executive Officers or Directors: Section 6.2-876 adopts the Federal Reserve Board Regulation O, 12C.F.R. part 215, with respect to maximum amount of loans and other extensions of credit a bank may make to any of its executive officers or directors, and the conditions and procedures for approval of such extensions of credit.

Overdrafts by Bank Officers or Directors: A bank may not pay an overdraft of its executive officer or directors, unless the payment of funds is made in accordance with (i) a written, preauthorized, interest-bearing extension of credit plan that specifies a method of repayment, or (ii) a written, preauthorized transfer of funds from another account of the account holder at the bank. This prohibition does not apply to the payment of inadvertent overdrafts in an aggregate amount of \$1,000 or less, provided (i) the account is not overdrawn for more than five business days, and (ii) the member bank charges the executive officer or director the same fee charged to other customers of the bank in similar circumstances. (Section 6.2-877).

Offenses: Sections 6.2-938 through 6.2-946 of the Virginia Code describe various offenses related to banking and the penalties which are provided for violations of such laws. In some instances penalties may be imposed by the Commission. Other offenses carry civil liability and/or criminal sanctions.

Removal of Directors or Officers: Section 6.2-865 of the Virginia Code empowers the State Corporation Commission to remove a director or officer from office if, after a written warning to the director and the board, the director is found to have continued to violate any law relating to the bank or to have continued any unsafe or unsound practice in conducting the business of the bank. A director or officer removed from office by order of the Commission has the right to appeal his removal to the Supreme Court of Virginia within sixty days. (Section 6.2-865).

PART III

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