FARLEIGH WADA WITT
Attorneys

CREDIT UNION EXECUTIVE NEWS

January 13, 2011

SPECIAL EDITION
NEW NCUA GOVERNANCE RULES

NEW NCUA GOVERNANCE RULES — FCU FIDUCIARY DUTIES; INDEMNIFICATION AND MERGER DISCLOSURES

On December 16, 2010, NCUA issued its long awaited governance rules: Fiduciary Duties of Federal Credit Unions; Merger and Conversions. The new rules become effective January 27, 2011 and only apply to federal credit unions. The new governance rules will impact federal credit unions (FCUs) in the following areas:

- FCU Directors – new duties and standards for directors;
- Indemnification – new limits on indemnification protections;
- Mergers – increased disclosures to NCUA and members; and
- Bank Conversions – new comprehensive rules.

What started in January 2008 as a regulatory initiative designed to plug holes in the patchwork of rules governing savings bank conversions and how to protect members' interests, NCUA's new governance rules do far more than that. NCUA has further expanded its regulatory grip on corporate governance for FCUs and created further differences in the law applicable to FCUs and state chartered credit unions for corporate governance.

The new bank conversion regulations go a long way to provide strict requirements and necessary guidance to protect credit union members' interests in credit union/bank conversion transactions. However, few if any credit unions are currently seeking or even considering such changes. Those that are will want to carefully study the new rules as the landscape for conversions has certainly changed.

More relevant to FCUs today are three areas of NCUA's Fiduciary Rule that we will discuss in this article:

- Director duties and standards;
- Indemnification; and
- Merger disclosures.

NCUA's rule establishes, for the first time, a federal standard of duties for directors of FCUs.

Director Duties and Standards

NCUA's rule establishes, for the first time, a federal standard of duties for directors of FCUs. The rule sets forth four specific duties and standards in a new Section 701.4 that each director must perform. Before we analyze each of the four duties, there are two overriding aspects of the NCUA's Fiduciary Rule that are important to note: the scope of the duties and to whom the duties are owed.

a. Nature of Director Duties – General or Fiduciary? NCUA's rule incorporates the traditional fiduciary duties of loyalty and care, which are distinctly recognized by well settled case law throughout the country. Oddly, however, the only reference to the term "fiduciary" is in the title to the rule. The new NCUA director duties are <u>not</u> the traditional fiduciary duty standards that apply to corporate directors under state law or the Model Business Corporation Act (MBCA). Instead, NCUA modeled the director duties, in part, on regulatory standards prescribed for Federal Home Loan Bank directors and added skill and competency duties. These FCU director duties include:

- Combined duty of loyalty and care;
- Duty of impartiality and nondiscrimination;
- Duty of financial competence; and
- Duty of legal compliance.

The latter three duties are really "general duties" that would be expected of any credit union director. They are certainly not well recognized fiduciary duties. The relevance and importance of these new standards for FCUs versus traditional fiduciary duties will arise in future litigation regarding FCU directors. And how the substantial body of case law on fiduciary duties is applied in credit union cases, if at all.

NCUA states in the Supplementary Information issued with the rule that the rule does not create a private right of action. In other words, NCUA is the only body empowered to enforce these duties. NCUA states that any action by members must be brought under existing state law principle. This leaves open the question of whether a state court would look only to traditional fiduciary duties in evaluating director actions or would use the NCUA rule as a substitute for existing state law standards.

NCUA also noted that the "business judgment rule" does not apply to its enforcement of the new fiduciary standards. The "business judgment rule" is a nearly universally recognized principle of corporate law. It holds that directors will not be liable to a corporation or its stockholders for business decisions made by the directors in good faith, with due care, without conflicts of interest, and that the directors reasonably believed to be in the best interests of the corporation. This rule was the basis for a recent federal court's tentative decision to dismiss most claims against former Wescorp directors. In determining that the business judgment rule does not apply to its fiduciary duties rule, NCUA is indicating its freedom to scrutinize board decisions, even if the decision-making process satisfied the traditional fiduciary duty standards.

b. Duty Owed to the FCU Membership as a Whole. Another aspect of NCUA's rules that makes the new federal fiduciary standard unique is the issue of: to whom the duty is owed. NCUA wrestled hard with this one. In the proposal, NCUA drafted the duty as one strictly owed to the membership of the FCU, not the Credit Union. This raised the questions of which members are the duties owed to, and who "represents" these members? In contrast, the MBCA and considerable legal authority related to corporations and nonprofit corporations provide that the director's duties are owed to the corporation.

In the final rule, NCUA revised the standard with a compromise. The FCU directors' duties are not owed to any particular constituency but are still owed to the "membership of the federal credit union as a whole," which makes this standard truly unique to FCUs. Directors of state chartered credit unions, on the other hand, would look to state law and the more traditional view. This issue takes on critical importance when directors must respond to or defend against a distinct group of members advancing a particular cause or issue.

c. New Director Duties. NCUA created four distinct duties that each FCU director must follow. Again, these include some commonly recognized fiduciary standards as well as general skill and competency requirements.

1. <u>Duty of Loyalty and Care</u>. There are two elements of this duty that an FCU director must carry out in his or her performance:

- Act in good faith, in a manner the director believes to be in the best interests of the membership of the federal credit union as a whole (loyalty); and
- Act with care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances (care).

NEW NCUA GOVERNANCE RULES — FCU FIDUCIARY DUTIES (CONT.)

2. Duty of Impartiality and Nondiscrimination. NCUA borrowed this particular standard from Federal Home Loan Bank regulations and made it applicable to FCU directors. These are important standards of behavior or best practices, but are not traditionally recognized as fiduciary duties.

An FCU director must administer the affairs of the FCU fairly and impartially and without discrimination in favor of or against any particular member. While the language of this duty seems to invite member litigation, NCUA properly clarified in the final rule that no member or group of members has a private cause of action against a director or even an implied right of action. This means that only NCUA can enforce violations of this duty.

3. Financial Competency. All directors must be expected to exhibit a minimum level of competence and responsibility regardless of specific background, skills or experience. However, financial competency is now a formal requirement. This was one of the most controversial provisions of NCUA's rule and again creates a new federal standard beyond traditional fiduciary duties. Furthermore, this standard is more than just financial literacy.

This standard establishes financial competency requirements for all directors, current and new. Each FCU must have a working familiarity with basic finance and accounting practices including: (i) the ability to read and understand the FCU's balance sheet and income statement; and (ii) ask, as appropriate, substantive questions of management and the internal and external auditors. FCU directors who may possess other nonfinancial or accounting skills or background must come up to speed quickly with their financial competency.

An FCU director must either possess such financial knowledge at the time of election or appointment or acquire such knowledge within six (6) months. Because this is such a new standard, NCUA set a July 27, 2011 effective date for this duty.

So current directors, elected or appointed before January 27, 2011, have until July 27, 2011 to develop or prove their financial competency. After January 27, 2011, any elected or appointed director will have six (6) months to develop their financial competency.

FCU nominating committees can, and should, now clearly establish financial competency as a director qualification for applicants and nominees. NCUA's rule does not mandate financial or accounting training, but requires a "working familiarity" with financials. Again, this goes beyond financial literacy and will clearly require financial education for some, if not many, directors. The hard part of the rule is how to determine if a director has met the financial competency standard. Some level of formal Board education needs to be conducted and documented. While there will be many industry developed education and training opportunities emphasizing financial literacy, the best education is gained internally with CEO and CFO led educational sessions on the financials applicable to and used by your FCU.

Financial competency is a standard requirement under Sarbanes-Oxley and makes good sense for credit unions. Many credit unions already provide such in-house Board education, but now the NCUA will require that no director is left behind in financial education.

4. Legal Compliance. Compliance with the law is not only important, it is expected, if not implicit, with the position. Noncompliance with the law would be grounds for Board removal and loss of bond coverage for individual directors and possible sanctions to the institution. NCUA has now made this a general duty for an FCU director. The new rule is fairly broad and requires an FCU director to direct the operations of the FCU in conformity with the FCUA, NCUA governing rules (Part 701), other applicable law, and "sound business practices."

Again, this rule does not provide any private right of action by members, but does provide disgruntled members an added formal standard under which they might seek removal of a director including the failure to follow sound business practices. Also, NCUA could use this standard as another tool to direct and control the actions of an FCU Board. At the same time, this duty may offer a shield for an FCU Board member against regulatory dictates that go against sound business practices of the credit union.

The new NCUA director duties do raise the bar on the duties and responsibilities expected of an FCU director. The active and conscientious directors should not need to change their actions or performance. However, each FCU director should recognize that NCUA has now laid in place yet additional standards and requirements by which they can scrutinize and regulate FCU Boards.

NEW NCUA GOVERNANCE RULES — FCU FIDUCIARY DUTIES (CONT.)

These standards are in line with traditional director fiduciary duties. Therefore, despite the uniqueness of the NCUA's new federal duties, FCU directors can meet the standards of these fiduciary duties by performing many well recognized activities such as the following:

Exercise Fiduciary Duty of Loyalty

- Disclose conflicts and issues to Board
- Recuse/abstain from deliberations on interested matters
- Document discussions and reasons for making decision
- Be careful with loans to officials

Exercise Fiduciary Duty of Care

- Inquiry about issues and don't let questions go unasked
- Read reports, informational materials
- Attend and participate in meetings
- Take the time and do the work necessary to perform duties, make decisions
- Get outside help when needed/Use outside professionals
- Know the Board's functions and duties
- Get education, including financial education
- Prepare and attend for meetings (review materials, be ready to ask questions, raise issues); Follow-up on missed meetings
- Review and understand financial reports and other operational information carefully

d. Authority Regarding Staff and Outside Consultants. In addition to the general duties required of an FCU director, NCUA provided corresponding authority to each FCU director in carrying out his or her duties and responsibilities. These authorities recognize the traditional corporate decision making authority, supervision and oversight authority and ability to delegate to management, but also empowers FCU directors to act beyond typical Board-management boundaries in two respects.

First, the rule confers authority not only on the Board, but also on any committee of the Board to retain outside advisors and professionals. Second, the authority specifically refers to the Board's authority to "retain staff" and require such staff to report directly to the Board, two actions that are inconsistent with most current Board governance models. This authority rule is broad and generally provides:

- The Board and all Board Committees have authority to retain staff, outside counsel, independent accountants, financial advisors and other outside consultants at the expense of the FCU.

- FCU staff retained by the Board may be required by the Board or Board Committee to report directly to the Board or Committee.

- In the absence of contrary information, an FCU director can rely on information, opinions, reports, statements or data of management to whom they have delegated authority or legal counsel, independent public accountants or other experts retained by the Board.

Generally, a director must comply with the standard of care in making a judgment as to the reliability and competence of the source of information upon which he or she relies. Of course, the director must also have read the information, opinions or reports or attended the meetings at which such information was presented or disclosed. Similarly, reasonable reliance means directors must consider the skills, expertise and competence of the retained professionals and experts.

FCU Boards will want to review their existing Board Policies on governance, code of ethics and similar policies to update such policies with these expanded authority rules.

Indemnification

NCUA Regulation 701.33 currently authorizes an FCU to provide indemnification for its officials and employees consistent with state law or the MBCA. An FCU that elects to provide indemnification has several options to document its indemnification commitment: (i) FCU Model Bylaw Article XVI, (ii) by agreement, or (iii) Board resolution or policy consistent with such state law or MBCA. In addition, an FCU can purchase insurance for its officials and employees to protect them in serving in their official capacity and performance of their duties.

a. New NCUA Indemnification Restrictions. In a continued attempt to frustrate credit union/bank conversions, the NCUA is limiting indemnification where director actions do not meet indemnification standards. In the course of several credit union/bank conversions, credit unions indemnified their Board and employees when member lawsuits were filed. Based on the premise that such conversions are basically wrong, NCUA believes indemnification in these cases would also be wrong.

NEW NCUA GOVERNANCE RULES — FCU FIDUCIARY DUTIES (CONT.)

In its rule, NCUA declared that FCU officials and employees will be personally accountable for violation of their fiduciary duties. As a result, NCUA added new restrictions on an FCU's ability to indemnify its officials and employees in 701.33(c)(5) in conversion actions.

An FCU may not indemnify an official or employee for personal liability related to any decision made by that individual on a matter significantly affecting the fundamental rights and interests of the FCU's members where a court has determine the individual's conduct was grossly negligent, reckless or willful misconduct. While the universe of actions FCU Boards may take that affect the fundamental rights and interests of its members is broad, NCUA narrowly defined such actions to two extraordinary events: charter conversions (credit union to bank) and share insurance conversions or terminations.

Interestingly, important corporate actions such as mergers, branch expansion or closures, field of membership expansions, or conversion to a federal or state credit union charters are <u>not</u> treated as matters significantly affecting members' interests in the FCU to warrant limitations on indemnification.

If your Board is not considering a bank conversion or converting to private share insurance, your existing indemnification protections are not subject to NCUA's new limitations, and this new limitation should <u>not</u> discourage Board members with the threat of personal liability.

b. FCU Model Bylaw Changes. NCUA made changes to the FCU Model Bylaws for indemnification and how it is applied.

First, NCUA added a cleanup provision in the final rule Section 701.33(c)(7), to resolve the conflict between the fiduciary duties owed to members v. fiduciary duty owed to the credit union issue discussed above. The conflict arises from FCU Bylaw Article XVI that references state law or the MBCA, which recognizes the fiduciary duty as owed to the corporation and NCUA's new rule stating that the duty is owed to members. NCUA's clarification is simply a declaration that a credit union must substitute the phrase "in the best interests of the members" for any language such as "in the best interest of the credit union or corporation." NCUA's resolution is somewhat troubling in that it fully recognizes that state law standards are different yet feels it necessary to create a unique federal standard. Moreover, the substitute language speaks of "members" not "membership of the FCU as a whole" as provided in the new director duties portion of the regulation.

Second, NCUA has added language in the beginning of Article XVI, Section 8 that cross-references its new limitations on indemnification under 701.33(c)(5) through (c)(7). This is pure housekeeping on NCUA's part, and FCUs need not adopt any changes to Article XVI. After all, the indemnification limitation is now in the regulation itself, which trumps any Bylaw to the contrary.

c. FCU Board Planning - Revisions to FCU Bylaws or Indemnification Agreements? NCUA's new Fiduciary Duty rule certainly adds new duties and specific responsibilities for FCU directors.

Accordingly, FCU Boards should take important steps that encourage rather than discourage the service of their directors. These actions should include: (i) a thorough education on director duties and liabilities; (ii) financial education to meet financial competency requirements; and (iii) strong indemnification protections and insurance coverage that protects and supports directors. FCU Boards should implement the greatest indemnification protections possible to protect the directors.

FCUs must take great care in securing the proper indemnification coverage for directors. Simply copying the FCU Model Bylaw Article XVI and checking either state law or MBCA is inadvisable. First, the MBCA is just a "model law" adopted by an American Bar Association Committee and is not actually law. Also, there is no body of case law deciding provisions of the MBCA.

In selecting your state law, you need to identify what state law applies. A general reference to "state law" is unhelpful, if not dangerous. After all, most states have various laws that could apply: corporations, non-profit corporations, etc. In most cases, your state's statutory provisions applicable to corporations should be referenced as they will generally contain the broadest protection and certainly will have judicial decisions interpreting such laws. Of course, a review of your state law is essential to confirm this approach.

In addition to the Bylaw obligation for indemnification, we recommend the Board adopt an Indemnification Policy or Guidelines so the FCU directors can fully understand the protection. Again, FCUA Model Bylaw Article XVI only cross-references state law indemnification provisions, it does not articulate or explain them. Furthermore, a Board Policy will not be a canned document dictated by NCUA like the Bylaws. The Policy can be tailored specifically to your FCU consistent with applicable law.

NEW NCUA GOVERNANCE RULES — FCU FIDUCIARY DUTIES (CONT.)

The FCU could provide individual indemnification agreements for its directors. However with Bylaw provisions, this is a belt and suspenders approach, which may have limited utility. We don't think you can provide any greater protection under an indemnification agreement than you can from Bylaws and you do not want to risk an administrative oversight of lost or unsigned indemnification agreement. Instead, we believe the Bylaws plus a Board Policy approach will afford the greatest protection and clarity for your FCU directors to understand and administer. If you already have indemnification agreements they should be reviewed and may need to be amended to avoid inconsistencies with the new NCUA's limitations.

Merger Disclosures

NCUA made some minor changes to Part 708b related to credit union mergers. The changes include new definitions and new disclosure requirements for merger plans submitted to the NCUA and the summary of merger plans distributed to voting members.

a. Definitions. NCUA adopted two new definitions that support the new disclosures required in a merger plan—the terms "merger-related financial arrangement" and "senior management official" as set forth below:

- Merger-related financial arrangements must be disclosed to NCUA as part of the merger plan and to voting members. A "merger related financial arrangement" means a material increase in compensation (including indirect compensation, for example bonuses, deferred compensation, or other financial rewards) or benefits that an FCU Board member or senior management official of a merging credit union may receive in connection with a merger transaction. For purposes of this definition, a material increase is an increase that exceeds the greater of 15% or $10,000.

- "Senior management official" means the CEO/President, any assistant CEOs and the CFO.

b. New Disclosures. In preparing and submitting a merger plan for approval by NCUA and disclosure to members, FCUs will need to provide additional disclosures.

Merger Plan Disclosures

- Merger-Related Financial Arrangements. First, the FCU must disclose and describe any merger-related financial arrangement. Thus if a senior management official is getting a retention bonus, salary increase, new or increased deferred compensation package in connection with a merger, either before or following the merger, such financial arrangement needs to be disclosed and described. The actual compensation documents need not be provided, but the senior management officials involved and amount of increases will need to be divulged.

- Share Adjustments. An FCU will need to explain any proposed share adjustments where the net worth ratio of the merging credit union is more than 500 basis points higher that the net worth ratio of the continuing credit union along with an explanation of the factors considered in establishing the amount of any proposed adjustment or determining that no adjustment is necessary. Rarely do merging credit unions make share adjustments to reflect differences in net worth contributed to the continuing credit union. Now, at least in the case where the merging credit union is better capitalized, disclosure of the factors and analysis of the share adjustment or lack of share adjustment needs to be made.

- HSR Statement. Currently, merging credit unions with assets above the $63.4 million FTC threshold for mergers, must consider and make a premerger notification filing. This filing, or an explanation of no filing, is now a required merger disclosure.

Summary of Merger Plan to Members Additions

The Summary of the Merger Plan provided to the members voting on the merger will now include additional information. NCUA expanded the scope of information to include:

- A detailed description of any merger related financial arrangements including the name and title of each recipient and an explanation of the financial impact of each element of the arrangement (direct salary increases and indirect compensation, bonus deferred compensation or other financial reward).

FARLEIGH WADA WITT
Attorneys

FCU FIDUCIARY DUTIES (CONT.)

(*Note: Of any issues that raise the concern of members of merging credit unions, executive compensation is generally the hot button issue. If you are considering merger related financial arrangements be prepared to make the disclosures and defend the arrangement – it will not go unnoticed.)*

- Explanation of any proposed share adjustments.
- Explanation of changes to any insurance coverage (life savings, loan protection or share insurance).

This is just the latest in a series of increased governance regulation that NCUA has placed on FCUs. You can expect more after the next crisis or perceived abuse.

Farleigh Wada Witt
Corporate Governance Resources and Expertise

Farleigh Wada Witt has extensive expertise and provides comprehensive resources for credit unions in the area of mergers, corporate governance guidance and Board planning and executive compensation.

If you have any issues or need planning or support for your Board please contact us.

Brian Witt
503.228.6044
bwitt@fwwlaw.com

Hal Scoggins
503.228.6044
hscoggins@fwwlaw.com

Congratulations to our client First Technology Federal Credit Union in completing its merger of First Tech Credit Union and Addison Avenue Federal Credit Union effective January 1, 2011!

Farleigh Wada Witt—One of Oregon's 100 Best Companies to Work For

We are proud to announce that our law firm has again been selected as one of Oregon's Best 100 Companies to work for. Yes, even law firms can be fun and rewarding places to work. Thanks to all of our professionals and staff for such great teamwork.

FARLEIGH WADA WITT
CREDIT UNION ATTORNEYS:

Brian Witt ……………………………….bwitt@fwwlaw.com
Hal Scoggins ……………………….hscoggins@fwwlaw.com
Jeff Martin ………………………… jmartin@fwwlaw.com
Dean Sandow ……………………….dsandow@fwwlaw.com
Valerie Tomasi ……………………..vtomasi@fwwlaw.com
Dave Ludwig ………………………..dludwig@fwwlaw.com
Kathy Salyer ………………………...ksalyer@fwwlaw.com
Michelle Bertolino ……………..mbertolino@fwwlaw.com
Kimberley McGair ……………….kmcgair@fwwlaw.com
Kelly Tilden ……………………………ktilden@fwwlaw.com
Marisol McAllister …………….mmcallister@fwwlaw.com

Portland Office:
121 SW Morrison Street, Suite 600
Portland, OR 97204
Phone: 503.228.6044
Fax: 503.228.1741

Central Oregon Office:
750 Buckaroo Trail, #203
Sisters, OR 97759
Phone: 541.549.4958
Fax: 541.549.4959

www.fwwlaw.com

Who Stands Behind Your Credit Union Compliance?