HUNTON& WILLIAMS

Client Alert

December 2017

Golden Parachutes and Indemnification, Part II

In a previous client alert, we discussed some lessons learned from navigating the golden parachute regulations efore the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC"). This client alert will cover the golden parachute's companion provisions related to indemnification payments. Unlike the golden parachute provisions, the indemnification provisions apply to insured depository institutions and their holding companies at all times, regardless of those entities' financial health.

What is an Indemnification Payment?

The legislative history of the Fraud Act, which added section 18(k) to the FDI Act, makes it clear that the indemnification provisions are intended to (i) preserve the deterrent effects of administrative enforcement or civil actions by insuring that institution-affiliated parties ("IAP") who are found to have violated the law, engaged in unsafe or unsound banking practices or breached any fiduciary duty to the institution, pay any civil money penalties and associated legal expenses out of their own pockets without reimbursement from the institution or its holding company, and (ii) safeguard the assets of financial institutions by prohibiting the expenditure of funds to defend, pay penalties imposed on or reimburse institution-affiliated parties who have been found to have violated the law.[1]

12 U.S.C. § 1828(k)(5)(A) defines an indemnification payment as

> [. . .] any payment (or any agreement to make any payment) by an insured depository institution or covered company for the benefit of any person who is or was an institution-affiliated party, to pay or reimburse such person for any liability or legal expense with regard to any administrative proceeding or civil action instituted by the appropriate Federal banking agency which results in a final order under which such person–
>
> (i) is accessed a civil money penalty;
>
> (ii) is removed or prohibited from participating in conduct of the affairs of the insured depository institution; or
>
> (iii) is required to take any affirmative action described in section 8(b)(6) with respect to such institution.

The regulatory definition of a "prohibited indemnification payment" at 12 C.F.R. § 359.1(l) tracks the statutory definition, except with respect to the third prong, which instead reads

> [. . .] (iii) is required to cease and desist from or take any affirmative action described in ***section 8(b)*** of the Act with respect to such institution. [Emphasis added.]

[1] 136 Cong. Rec. E3687 (daily ed. November 2, 1990) (statement of Rep. Schumer).

Prong (iii) in the statute refers explicitly to 12 U.S.C. § 1818(b)(6). However, the FDIC's regulations under 12 C.F.R. 359 contain a subtle distinction and reference the entire section 8(b).

While subtle, the difference could potentially be significant. The statute arguably prohibits indemnification only in situations where the final order contains a provision requiring the institution to take one of the specific actions enumerated in 12 U.S.C. § 1818(b)(6) (*i.e.*, provide restitution, restrict growth, dispose of a loan or asset, rescind agreements or contracts, or employ qualified officers). Absent one of these specific actions in the final order, and if there is no civil money penalty or removal or prohibition provision in the final order, indemnification is permissible. However, the regulatory definition of a "prohibited indemnification payment" would appear to prohibit indemnification payments in a broader set of circumstances. Because the regulatory definition references "section 8(b)" rather than "section 8(b)(6)," ***any*** final order containing a cease or desist provision or affirmative action provision premised on a violation of law or unsafe or unsound practices (which is practically any final order) would render indemnification impermissible.

There does not appear to be any guidance from the FDIC on the distinction between the statutory and regulatory definitions of this key term. When we raised the question with FDIC staff, they acknowledged that it was an interesting issue, but could not provide guidance as to whether the regulatory definition of an indemnification payment was purposely drafted to be broader than the statutory definition.

The Indemnification Provisions Incentive Early Settlements with the Regulators

As a threshold matter, indemnification is only prohibited with regards to "administrative proceedings or civil actions." What do these terms mean? An "administrative proceeding" is any legal proceeding initiated by a federal banking agency before an administrative law judge. A "civil action" is a case brought by a federal banking agency in federal court. However, neither of these terms apply to settlements entered into ***prior to*** the commencement of an administrative proceeding or a civil action. The vast majority of enforcement actions fit this criteria as they are entered into ***in lieu of*** a federal banking regulator commencing an administrative proceeding or a civil action. As stated in the 1996 final rulemaking, "[t]he FDIC considers a formal administrative action to be commenced by the issuance of a 'Notice of Charges.'"[2] The indemnification provisions, therefore, incentivize early settlements between the regulators and IAP. IAPs should be aware of this application of the indemnification provisions, and factor these considerations into their analysis of whether to settle an enforcement action prior to the commencement of an administrative proceeding or civil action.

The Indemnification Provisions Do Not Apply to Criminal Proceedings or Actions by Non-Federal Banking Agencies

By their terms, the indemnification provisions do not apply to actions initiated by anyone other than the bank's or holding company's primary federal regulator (*i.e.*, the OCC, the Board of Governors of the Federal Reserve, or the FDIC). In other words, the provisions do not apply to actions initiated by the Consumer Financial Protection Bureau, the Department of Justice, or by any other federal or state agency.[3] It is unclear how the regulations would apply in enforcement actions brought jointly by a state

[2] Final Rule, *Regulation of Golden Parachutes and Other Benefits Which May Be Subject to Misuse*, 61 Fed. Reg. 5,926, 5,930 (Feb. 15, 1996).

[3] Note that certain other federal regulators, notably the National Credit Union Administration and the Federal Housing Finance Agency ("FHFA"), have adopted their own indemnification regulations that are based on the FDIC's indemnification provisions (*see* 12 C.F.R. Part 750 (credit union golden parachute and indemnification rules); *see also* 12 C.F.R. Part 1232 (golden parachute and indemnification rules for FHFA-regulated institutions)). An analysis of those indemnifications is beyond the scope of this client alert.

bank's state regulator and primary federal regulator.[4] Notwithstanding the inapplicability of the indemnification provisions to such actions, insured depository institutions and their holding companies should carefully consider the implications of providing (or not providing) indemnifications in such situations.

Exception to General Prohibition – Director & Officer Insurance

Both 12 U.S.C. § 1828(k)(6) and 12 C.F.R. § 359.1(l)(2) expressly provide that certain director and officer insurance policies ("D&O Policies") are not included in the definition of "prohibited indemnification payments." D&O Policies are not permitted to directly pay for the cost of any final judgment or civil money penalty assessed against such IAP. But D&O Policies may cover legal and professional expenses incurred by an IAP that arise in connection with an administrative proceeding or civil action, including restitution that an IAP may be ordered to pay to the financial institution or its receiver. Therefore, while all of an IAP's legal expenses may be indirectly indemnified through D&O Policies, the bank or bank holding company may only directly indemnify an IAP for legal expenses if, generally, an IAP is exonerated in an administrative proceeding or civil action (as discussed below, legal expenses may be advanced under certain conditions, but must be reimbursed if, generally, the IAP is found guilty in an administrative proceeding or civil action). IAPs should carefully consult applicable D&O Policies to be sure they understand the scope of coverage of those policies.

Permissible Indemnification Payments – Written Determination by Board of Directors

12 C.F.R. § 359.5 provides criteria for making or agreeing to make permissible indemnification payments. A financial institution or a financial institution holding company may make or agree to make a reasonable indemnification payment if:

(i) the institution's board of directors, in good faith, determines in writing that the IAP acted in good faith and in a manner the IAP believed to be in the best interests of the institution;

(ii) the board of directors, in good faith, determines in writing that the payment will not materially adversely affect the institution's safety and soundness;

(iii) the indemnification payment does not fall within the definition of a "prohibited indemnification payment" (as discussed above); and

(iv) the IAP agrees in writing to reimburse the institution, to the extent not covered by a permissible D&O Policy, for payments made in the event that the administrative action results in a final order or settlement in which the IAP 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.

Prong (iii) above is not expressly required to be included in the board of directors' written determinations. But we advise, as a matter of good corporate practice, that the board of directors include in its written determinations that the board of directors, in good faith, believes the contemplated indemnification payment is not a prohibited "indemnification payment."

* * * * *

We hope this Part II client alert on golden parachutes and indemnification has been helpful in drawing attention to ways in the indemnification provisions impact holding companies, insured depository

[4] There may be an argument by analogy to 12 C.F.R. § 359.1(l)(2)(ii) that partial indemnification is permissible for expenses attributable to the state agency's charges.

institutions and IAPs. Should you have any questions in this area, please feel free to contact either of the authors listed below.

Authors

Carleton Goss
cgoss@hunton.com

Nathaniel B. Jones
njones@hunton.com