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Bank Advisory Boards Revisited: Avoiding Inadvertent Pitfalls

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Advisory boards can be, and typically are, a very helpful resource for seeking and obtaining important business and professional expertise, as well as community insights and input, for financial institutions. Advisory board members are often sought for those qualities and activities, and to serve as “good will ambassadors” for the institution, particularly in new markets or in seller markets that remain following bank charter consolidations. Advisory board members can also be an excellent source for institutional director succession planning candidates and provide a field of potential director replacements which are able to “hit the ground running” due to their knowledge of the institution and its people and practices.

Participation in an advisory board can be a win-win situation for the institution and for the advisory board member, if properly structured and documented. If not, unintended consequences can make the role uncomfortable and generate unintended problems for both the institution and the advisory board member. All parties need to be mindful of the role and responsibilities of the relationship, including limitations on activities and information, so as to mitigate potential issues and liability for the institution and for the advisory board member.

Structure and Role

The role of advisory board members should be carefully defined and evidenced by a written charter. The charter should provide guidance for the advisory board and its members and should be adopted by the “legal” board as well as the advisory board. The charter should delineate the role, expectations and activities of the advisory board and its members. In its true form, the typical advisory director role is actually more that of a “consultant” than a true director, and care must be taken to define and limit activities. Those limitations should be explained in detail to advisory board members with an acknowledgement of same before appointments are accepted. Written “contracts” with advisory directors can help to minimize misunderstandings with respect to the

role, responsibilities, expectations, and limitations of advisory board participation. Taking care up front to thoughtfully and carefully define the role of the advisory board member is designed to protect both the member and the institution.

Advisory board members should do just that; provide appropriate advice to the institution and its management. Inappropriately influencing and directing management on matters impacting the institution can create unintended “control” issues, as well as unintended exposure and liability for the advisory director and for the institution that should be carefully avoided. Training should be conducted for advisory board members, and a record of that training maintained by the institution.

Information

Advisory board members who receive material nonpublic insider information concerning the business of the institution, its customers, its strategic plans, and other material aspects of operations should be treated as “insiders” for purposes of trading in company stock and should be covered by the institution’s “insider trading policy” (including being subject to “blackout” periods/etc). As a practical matter, it is very difficult to avoid “insider” status if advisory board members are providing business direction to the institution and have access to nonpublic information concerning the institution and its customers. Whether advisory board members actually receive material nonpublic insider information varies depending on the circumstances of the institution and the role of the advisory board. However, those issues are unfortunately almost always viewed with 20-20 hindsight if and when problems arise. While “insider” restrictions may cause potential members to think twice about serving, even for closely-held institutions it is the safe route to take. For publicly-traded institutions, advisory board members could also be subject to SEC Section 16 “short swing” trading restrictions and reporting requirements. Care should be taken by advisory directors to consult with management, with legal counsel for the institution, and with personal legal counsel before engaging in any trades in company shares. The consequences of problems in this area can be significant regardless of whether the institution is publicly-traded or closely-held.

Customer privacy issues are also likely to arise, and advisory directors who receive customer information need to be informed and aware of, and guided by, the restrictions imposed on receipt of such information by applicable state and federal laws and regulations.

In all instances, care should be taken by the institution not to inappropriately provide access to business, shareholder, customer and regulatory information and data that is confidential as a matter of law or regulation. Advisory board members are not “management,” true “directors,” or “consultants” for purposes of access to otherwise confidential information and data. Inappropriate access to certain information, including confidential regulatory examination information and ratings, can lead to potential civil and criminal liability and it is in the best interests of the institution as well as the advisory board member to avoid those issues. Virtually all regulatory communications, ROE’s, ratings, and other interactions with regulators should be maintained outside of any access by advisory directors. In addition, confidentiality agreements between the institution and advisory directors are appropriate in most instances, and can be part of the overall advisory director contract relationship.

Conflicts of Interest

While, if properly structured, advisory board participants are not technically “directors” with defined fiduciary and other legal obligations to the institution and its constituencies that have been defined over the years by statute and case law, advisory board members should take care to avoid situations where the same kinds of concerns could arise. Members should be subject to the same “conflict of interest” policies as full board members, and the same disclosure obligations. Courts may well not distinguish between the roles if issues arise, and conflict of interest limitations applicable to directors of an institution may serve as “best practices” directions for advisory board members as well.

Apparent Authority

Education of advisory boards (and relevant charters and agreements) should include appropriate cautions regarding limitations on member authority, including the importance of avoiding situations that could create reliance by third parties on “apparent authority” of the advisory board member. The member has no authority to act on behalf of the institution or to bind the institution unless expressly granted by the board, and care must be taken to avoid creating the perception of authority to bind the institution in interactions with third parties.

Liability

While again not technically serving as a “director” for legal purposes, the role may entail exposure for the institution and for the advisory board member in conjunction with performance of advisory board functions and access to information. Exposure to the advisory director would not typically be covered by statutory or common law director protections, by standard indemnification provisions in the institution’s governance documents, or by standard D&O insurance. Likewise, exposure to the institution may not be covered by applicable bond, E&O, or other coverage. Institutions may wish to explore the availability (and cost) of special insurance for those situations, and prospective advisory directors may wish to discuss liability issues with the institution (and with personal legal counsel) before accepting that role and engaging in advisory board activities. Some personal umbrella policies held by participants may also provide some protection but should of course be checked.

Conclusions

Proper use of advisory boards and proper involvement of advisory directors can be an excellent tool for institutions and provide an enjoyable and fulfilling role for participants. The role and activities should, however, be carefully defined, explained to participants and limited as appropriate in order to endeavor to mitigate potential unforeseen and unintended liability issues for the institution and for the participating advisory board member.