



## LEGAL ALERT

January 25, 2016

### **EFFECTIVE CORPORATE GOVERNANCE: A DEFENSE TO SEC LIABILITY**

Failure of effective oversight over management and abdication of board responsibility concerning loan reviews, appropriate allowance for loan losses and troubled loan restructurings recently led to civil settlements with the SEC by nine officers and directors of Superior Bank in Alabama and its holding company for allegedly overstating its net income in public filings with the SEC (*see <https://www.sec.gov/news/pressrelease/2016-7.html>*). The SEC alleged that most officers and certain directors engaged in accounting fraud by concealing significant losses from loan impairments.

Although these nine officers and directors collectively are obligated to pay over \$1 million in civil penalties (which likely are not covered by D&O insurance), they also were permanently barred from being an officer or director of a publicly-held company. Such debarment no doubt will have an enormous adverse effect on their future employment prospects and even on existing business relationships outside of the banking sector.

In the above scenario, the audit committee clearly did not fulfill its responsibilities. The audit committee, which is to be composed entirely of independent directors, is responsible for oversight of the chief financial officer (who was one of the nine defendants), the outside auditor, internal audit practices and the internal controls over financial accounting. Although the board of directors may rely on the audit committee to properly perform its function and give deference to a recommendation by the audit committee for the board to approve the

financial statements of the company, it remains that the entire board is responsible for the financial information filed with the SEC.

If the bank was experiencing impaired loans and, as a result, was considering restructuring of those loans, the board, as part of its loan review responsibilities, should have established a procedure for reviewing those loans and the criteria for approving any restructuring of those loans, including appropriate disclosures in financial information filed with the SEC.

It is clear from the SEC's complaint that the board failed to exercise appropriate oversight over executive management in that the CEO and Chairman, CFO and Chief Credit Officer were alleged to have orchestrated separate accounting frauds by failing to impair more than \$250 million in substandard loans being actively marketed to third parties and failing to write-down to zero the value of a deferred tax asset being used to offset future income they knew would never materialize.

Robust corporate governance not only delivers value to shareholders, it also is effective in keeping executive management and directors informed and focused on important issues currently affecting the company. As indicated by the SEC action, effective corporate governance is particularly important during times of crisis by having clearly established board expectations of executive management and board committees. However, the time to establish these expectations is before a

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crisis occurs, not while it is happening with everyone trying to deal with multiple issues in an uncoordinated and uninformed manner.

Had the board of Superior Bank engaged in robust corporate governance procedures, this SEC action most likely would not have occurred which reinforces the proposition that good corporate governance policies and procedures can act as an effective prophylactic defense to regulatory and civil enforcement proceedings.

Being at the center of a SEC civil investigation or a Department of Justice criminal investigation inevitably results in significant time and capital being diverted to defense costs and shareholder relations rather than to the business of banking. Enforcement action by bank regulators (including suspension of dividends) may follow. In such circumstances, there is no doubt the company may suffer at least short term reputation damage but it also may become viewed as a target for acquisition as to which some company shareholders may have sympathy if they have lost confidence in the company applying sound corporate governance.

While these officers and directors may have put the SEC action behind them, the FDIC in 2014 instituted a civil suit against them in US District Court to recover \$44 million in damages (*see <http://www.tbo.com/news/business/fdic-sues-officers-of-failed-superior-bank-of-tampa-20140417>*). In 2014, the FDIC authorized filing of 123 civil lawsuits against bank officers and directors and another 26 suits in 2015 (*see <https://www.fdic.gov/bank/individual/failed/pls/>*).

The professionals at Bybel Rutledge LLP have decades of experience in the board rooms of Pennsylvania community banks. In the context of this depth of experience, we not only can deliver useful comparative information on good corporate governance practices but also can evaluate your current corporate governance practices and recommend and design enhancements.

### **Need More Information?**

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