March 15, 2011

John Annaloro, Chief Executive Officer
Northwest Credit Union Association
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Beaverton, OR 97008

Re: NCUA Rulemakings on Director Duties.

Dear Mr. Annaloro:

Sometime in late February, 2011, you and several other trade association executives wrote an undated letter to the NCUA Chairman and the other two NCUA Board Members. In the letter, you express concerns about the process and substance of two NCUA rulemakings (§701.4 and Part 750) and a related NCUA Letter to Federal Credit Unions No. 11-FCU-02 (the "LFCU"). The Chairman asked me to respond to your concerns. I address each of your concerns below, starting with the rulemaking substance, the rulemaking process, and then the LFCU.

§701.4, *General authorities and duties of Federal credit union directors*.

In your letter, you state your opinion that:

> *[NCUA's] rule creates a litigation trap for credit unions who may be accused of not acting in the interests of a particular faction of members of a credit union. It will be both expensive and time consuming for a defending credit union to prove that it acted in the best interests of all members collectively. In many instances the actions of the board, while not harming members, do not necessarily find immediate benefit for all members but instead bolster the institution itself.*

Although your letter is not specific, I presume that you are referring here to §701.4(b)(1), which says, in part, "[e]ach Federal credit union director has the duty to . . . carry out his or her duties . . . in a manner [he or she] reasonably believes to be in the best interests of the membership of the Federal credit union as a whole." Also, you do not provide a specific example or hypothetical of how this litigation trap might work, so I cannot respond specifically. Still, as discussed below, I do not believe that §701.4 creates any sort of litigation trap.

As a legal matter, I do not see how §701.4 increases the odds of a successful law suit against FCU directors. The NCUA Board stated specifically that §701.4 does not create any private cause of action against credit unions or credit union directors. *See* 75 Fed. Reg. 15574, 15578 fn. 11 (March 29, 2010) *and* 75 Fed. Reg. 81378, 81379 (Dec. 28, 2010). So the rule does not create any new litigation

possibility in that sense. Second, and contrary to the implication in your letter, §701.4 does not state or suggest that the burden of proof on any issue should be shifted to an FCU's directors. For example, if a third party brings suit against a director under existing state law, the burden of proof will be established under state law, and in most state causes of action the defendant directors do not carry any burden of proof unless the plaintiffs can first establish that the directors acted in bad faith or without appropriate due diligence. And, finally, there is nothing in §701.4 that states that directors must consider only the "immediate" benefit to the members of any action the directors take. Directors can consider, and are encouraged to consider, the long term benefits to the members of the directors' actions. The NCUA Board also addressed this issue in the preamble to the final §701.4. *See* 75 Fed. Reg. 81378, 81379 (Dec. 28, 2010).

The legal technicalities aside, I do not believe that a rulemaking clarifying that FCU directors owe their fiduciary duties to the membership of the FCU is a difficult concept or one that should surprise or concern directors. Section 701.4 is intended to make clear that the law with regard to federal credit unions is in direct alignment with the credit union philosophy; that is, that credit unions exist to serve their members; that credit unions are about people, not profits; and that the members own their credit unions. As the NCUA Board stated back in 2006 (and Chairman Matz reaffirmed in the recent LFCU), when making important decisions affecting the FCU, directors should ask themselves the following questions:

> *What financial services do my members need and want? How do I know this? [And] [w]ill my decision today help the credit union provide these member services in a quality manner and at low cost to the members?*

See LFCU, p. 5; and 71 Fed. Reg. 77150, 77155–56 (Dec. 22, 2006). Your letter, however, states that "[i]t is our position that the director's duty should be to the credit union as an organization, and not to the members of the credit union." I disagree. As the NCUA Board has discussed at length in rulemaking preambles going back to 2006, for federal credit unions the law (as determined by the FCU Act) and philosophy align: the directors' duties flow primarily to the membership. *Id*. at 77154-55. As a practical matter, however, we believe that in the vast majority of situations what is good for the credit union will also be good for the members. *See* 75 Fed. Reg. 15574, 15575 (fn. 5)(March 29, 2010). For example, decisions that facilitate the reasonable growth of the credit union are generally supportable because they can usually be tied to the economic viability of the credit union and the credit union's ability, going forward, to continue to provide members with high quality financial services at good prices. However, we also believe that fiduciary duties are properly owed to *people*, and not to *entities*. FCU directors must understand the people who are affected by the directors' decisions and identify which people the directors are serving. The danger is that, if the directors are allowed to focus only on the credit union when making a decision – without regard to how the members are affected – the directors can justify making self-

serving decisions, or decisions that serve primarily the FCU's insiders, under the guise that the directors are simply doing what is best for the credit union. In our view, FCU directors can *always* avoid this danger if, in connection with any major decision, the directors articulate how the decision, over time, will result in providing members the financial services they need and want at high quality and low cost.

You also expressed concern that it is difficult to make decisions that benefit all the members all the time. Although you did not give specific examples of your concern, the NCUA Board did address an issue like this in the preamble to the final §701.4 as follows:

> *One commenter was concerned that a focus on the membership as a whole might keep an FCU from developing new branches or ATMs because some members would be closer to the new branch or ATM and might find the new facility more convenient to use than other members. The Board recognizes that in the short term some members may benefit geographically from an FCU's expansion plans. Such marginal geographical benefits, or other marginal access benefits, will not by themselves cause an FCU expansion to violate the fiduciary duties of an FCU's Board.*

75 Fed. Reg. 81378, 81379 (Dec. 28, 2010). Similarly, directors often make decisions about savings rates and loan rates that require a balancing of interests between members who are primarily savers and those who are primarily borrowers. Such balancing, when done in a reasonable fashion and with regard to the needs of both types of members, will not violate the fiduciary duties of an FCU's board.

Part 750, *Golden parachute and indemnification payments.*

The indemnification provision of Part 750, as proposed by the NCUA Board at its July 2010 meeting, would generally prohibit a federally insured credit union (FICU) from paying or reimbursing an Institution Affiliated Party (IAP):

> *for any civil money penalty, judgment, or other liability or legal expense resulting from any administrative or civil action instituted by NCUA or any appropriate state regulatory authority . . . that results in a final order or settlement . . . .*

75 Fed. Reg. 47236, 47241 (Aug. 5, 2010). You suggest that this indemnification prohibition, if adopted by NCUA in final form, will have a negative effect on a FICU's ability to recruit qualified directors. You also assert that the proposed Part 750 gives NCUA too much authority over the credit union's own board and usurps the board's discretion to make its own decisions about whom to indemnify.

We recognize that a FICU's voluntary governance structure presents unique recruitment and retention challenges; however, the scope of prohibited

indemnification in Part 750, if adopted by the NCUA Board as proposed, is limited and should not present a challenge to recruiting or retaining directors. For example, the indemnification limitation applies only to actions brought by NCUA or the appropriate state regulator. Such actions by regulators against directors are not only rare, but when they occur they usually don't involve pecuniary liability but, rather, take the form of either a removal action or an action to prohibit an individual from serving on behalf of an insured depository institution in the future. In addition, the proposed Part 750 does not create a blanket prohibition on indemnification payments. Under certain conditions, a FICU may make indemnification available to an IAP prior to a finding of liability. In that case, the disinterested directors on a FICU's board of directors may make their own good faith determination that indemnification of a given IAP in a given circumstance is appropriate. The only circumstance in which this determination will be reversed is where the outcome of the agency's enforcement action or a settlement agreement results in a specific liability finding against the IAP. The proposed Part 750 also permits the board of directors to obtain liability insurance coverage for IAPs to cover the IAP's legal expenses where indemnification would be prohibited under Part 750.

Also, you should be aware that NCUA did not design this specific prohibition on indemnification – Congress did. Section 206 of the FCU Act has included this prohibition going back more than 20 years. 12 U.S.C. §1786(t)(1), (5)(A). The same prohibition exists for banks in the Federal Deposit Insurance Act, and about 15 years ago the FDIC put this prohibition into a rule that reads almost identically to the proposed Part 750. *See* 12 C.F.R. Part 359.

Rulemaking process.

You state that "we believe that these rules were both issued with abbreviated comment periods not proportionate to their potential impact, and respectfully request that the agency retract its golden parachute and indemnification rule in order to give the matter . . . additional study . . . " and that "the agency's far-reaching determinations in this area deserve deeper consideration and scrutiny." I disagree. I believe NCUA has pursued both rulemakings slowly, carefully, and with the necessary consideration and scrutiny.

With regard to the limited prohibition on indemnification in Part 750, the Board issued the proposed Part 750 for public comment more than seven months ago. NCUA received 17 comments and carefully considered each comment. While the formal comment period of 30 days was shorter than NCUA's standard 60-day comment period, the Board has not yet acted on a final Part 750, and interested parties may continue to interact with the Board and NCUA staff on this proposal.

I do believe that the issues presented by Part 750 have been fully aired going back even before July of 2010. For example, the text of Part 750 is virtually identical to

the text of §704.20, which applies to corporate credit union directors. 12 C.F.R. §704.20. NCUA issued proposed revisions to the corporate credit union rule, including adding the indemnification limitations contained in §704.20, back in 2009, and, after receiving hundreds of comments on the proposed corporate rule revisions, NCUA finalized those revisions (and §704.20) in September 2010.

With regard to §701.4, it clarifies that FCU directors owe their fiduciary duties to the membership. This concept, however, did not originate with §701.4. As discussed above, the Board stated that FCU directors owe their duties to the membership, and laid out the legal authority for this statement, more than four years ago. *See* 71 Fed. Reg. 77150, 77154 – 56 (Dec. 22, 2006). Then, following an advance notice of proposed rulemaking in 2008, the Board issued the text of proposed §701.4 for public comment in March 2010, and the 60-day public comment period closed on May 28, 2010. NCUA received some 40 comments on proposed §701.4 and, again, considered every comment. Even after the close of the public comment period, NCUA did not move to adopt §701.4 in final until December 2010 --- and so a period of nine months elapsed between issuance of the proposed and final rules. I believe the process for each rulemaking has permitted adequate time for comment, consideration, and study.

LFCU No. 11-FCU-02, *Duties of Federal Credit Union Boards of Directors.*

LFCU No. 11-FCU-02, issued by NCUA in February 2011, provides additional information about the duties of FCU directors with an emphasis on the financial literacy requirement. Much of what you have to say about the LFCU echoes your concerns with §701.4, and those particular concerns are answered above. You also had two additional concerns specific to the LFCU.

First, you expressed concern that "the [LFCU] . . . appears to give credit union boards of directors free reign to hire independent experts (and staff!)." As provided for in the FCU Act, an FCU's board of directors sits at the very apex of the credit union. The directors are responsible for the general control and direction of the credit union, and the FCU's CEO and management work for the board. The FCU board's duties include hiring the CEO and "any other employees [the directors] deem necessary to carry out the credit union's operations." FCU Handbook, page 14. At the board's discretion, it may hire some individuals who report directly to the board and not through senior management, particularly where the board feels it needs advice to properly evaluate or guide the performance of senior management.

Second, you expressed concern about the phrase in the LFCU stating that an FCU's board of director's "must directly exercise its authority to hire, fire, determine duties, set compensation, and discipline senior management." Other individuals also sought clarification of this phrase, and I issued a clarification in the attached NCUA Office of General Counsel (OGC) opinion letter on an FCU

board's authority to delegate personnel functions. OGC Op. No. 11-0221 (Feb. 24, 2011).

Conclusion.

At the very beginning of your letter, you do not state that you are writing to NCUA on behalf of credit unions. Instead, you and your fellow authors state that "[a]s associations representing 18,280,456 members in nine states . . . we want to call your attention to several key issues . . . ." I presume that by "members" you mean the people who are members of the credit unions in your states, and I commend you for attempting to look beyond credit unions as entities and through to the people that credit unions were structured to serve. As our rulemakings make clear, the directors of federal credit unions must also represent the interests of the members of their credit unions.

In sum, I believe these NCUA rules align the law on FCU director duties with the long-standing, member-centric credit union philosophy. I do not see anything about these rules that will increase the odds of successful litigation against FCU directors, or that should make it more difficult to recruit and retain qualified directors, or that should otherwise trouble FCUs or FCU directors who serve the credit union philosophy.

Sincerely,

/S/

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GC/PMP:bhs

11-0344

Attachment

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