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OCC Proposes Widespread Codification to Corporate Governance Rules for National Banks and Federal Associations

Douglas P. Faucette*

The author of this article discusses a recent Office of the Comptroller of the Currency Notice of Proposed Rulemaking relating to the activities and operations of national banks and federal savings associations, which would, among other things, expand the scope of a national bank's choice of law.

The Office of the Comptroller of the Currency ("OCC") has issued a Notice of Proposed Rulemaking ("NPR") to revise and reorganize its regulations relating to the activities and operations of national banks and federal savings associations. The NPR covers a wide range of digital activities and permissible national bank and federal association activities. Significantly, it also constitutes comprehensive guidance for incorporation of state law pertaining to corporate governance of a national bank. Currently, the OCC regulations authorize a national bank to use the corporate governance provisions of the state in which the main office of the bank is located, the state in which the bank's holding company is located, the Delaware General Corporation Law, or the Model Business Corporation Act.

NOTICE OF PROPOSED RULEMAKING

The NPR, however, would expand the scope of a national bank's choice of law. It would revise paragraph (b) of Section 7.2000, 12 CFR 7.2000, to authorize a national bank to elect the corporate governance provisions of the law of any state in which any branch of the bank is located, in addition to the law of the state in which the bank's main office is located, to the extent not inconsistent with applicable federal banking statutes or regulations or safety and soundness. In addition, the NPR requests comment on whether a national bank should be able to adopt a combination of provisions, a sort of governance smorgasbord, from the various jurisdictions in which it or its holding company are located in addition to the Model Act and Delaware law. Finally, a national bank whose corporate governance law was selected as the law governing the holding company may continue to apply that law even if the holding company

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ceases to control that bank. This NPR, while liberalizing, requires that the implementation be made by an amendment to the bank's bylaws.

Under the NPR, there are a number of qualifications that may make the adoption of particular state law provisions highly problematic in a contentious shareholder environment. That is, an election of choice of law is subject to a OCC self-initiated or bank requested review on a case by case basis with vague or no guidance as to the standards for approval. Indeed, the proposed regulation provides that "based on the substance of the provision or the individual circumstances of a national bank," the OCC may determine an individual provision to be ineffective.

The regulation also provides that a national bank *may not elect* any state law anti-takeover provision that may impede a capital infusion, with prescribed examples of impedance circumstances as including a merger, acquisition, proxy contest or director removal, among other things. While this exception swallows the rule, the NPR provides that such provisions can be adopted if at the time of adoption by the national bank it includes in the impedance (antitakeover) provision in its bylaws or articles a clause that makes ineffective such provisions in the future in the event that certain conditions exist. The conditions are: the national bank is less than adequately capitalized, is in troubled condition, is otherwise in less than satisfactory condition or grounds exist for the appointment of a receiver for the bank. In addition to the absence of the listed conditions existing at the time of adoption, its articles or bylaws must also contain a provision making the antitakeover provision ineffective in the event the "OCC otherwise directs the bank not to follow the provision for supervisory reasons."

While the initial thrust of the NPR is quite liberalizing and would give a bank an unprecedented range of choice of laws, even to the point of selecting a patchwork of jurisdictions for individual antitakeover and other governance provisions, the many qualifications that are attached to that choice limit it to such an extent as to make any choice unreliable in a challenge.

There is a threshold question whether the state or federal courts will respect a combined elections of law if the most liberal provision suggested were adopted or even the version currently proposed that allows choice of the law of a state where the bank may have minimal contacts. In the highly litigious environment of a contest for control of a bank, adversaries will not hesitate to challenge unorthodox applications of choice of law theories. This is even more likely given the current trend line involving court decisions on the validity of choice of law as part of contractual agreements. There has been a trend of court decisions where courts are increasing their requirements for an actual nexus to

the jurisdiction chosen. Ironically, states will be deciding federal law to the extent they interpret the validity of a state antitakeover provision applied pursuant to a federal OCC regulation.

THE NPR ALSO SEEKS COMMENT AS TO WHETHER THE PROVISIONS APPLICABLE TO NATIONAL BANKS SHOULD BE APPLIED TO FEDERAL STOCK AND MUTUAL ASSOCIATIONS

The word "mutual" is mentioned only once in the NPR, in a reference to Section 5.21, the regulation which applies to mutual corporate governance. As federal associations have an entirely different enabling Act, it is not clear that an application of the same governance rules applicable to national banks to federal associations is a good fit. For example, the regulations applicable to federal stock banks allow limits on voting and various other antitakeover provisions that the OCC deems unlawful for national banks.

Moreover, mutual associations are a distinct and very different entity from a governance perspective. Stock federal associations subsidiaries of mutual holding companies ("MHCs") are an altogether different creature of law. In that case, under Reg MM, the Federal Reserve Board charters and dictates the corporate governance of the MHC but the OCC prescribes governance for the subsidiary stock bank. That is not to say that the governance provisions for federal mutuals do not need updating. Indeed, they do, and should not be treated as the same as those applying to stock national banks. Arguably, there is a more compelling case to bring the governance of mutuals into the 21st century and plug any loopholes that have been exploited by professional investors seeking to terminate their mutuality. It is no accident that a significant number of federal mutuals have elected to convert to mutual savings banks in states with favorable mutual savings bank statutes. As with so many other regulations one size does not fit all.

ANTITAKEOVER PROVISIONS

The NPR includes a discussion of various areas of corporate governance ranging from antitakeover provisions to a requirement that a person performing the duties of president be a director to combining the indemnity provisions applying to institution affiliated persons of national banks in a regulation applying to federal associations. None of these proposals are simple and the indemnity proposal is particularly troublesome for federal associations and would likely conflict with various contractual documentation already in existence.

But for the various qualifications discussed above, the section of the NPR which offers the OCC's views on common antitakeover bylaw and charter

provisions would be empowering and offer a reviewing court a clear roadmap for the validity of an antitakeover provision under OCC rules and laws. As if the various qualifications were not enough of a burden, the preamble states: "[w]hile the OCC has concluded that the types of provisions set out in paragraph (b) are not inconsistent with Federal banking statutes and regulations in general, the specific provision a particular bank adopts may contain features that could change the result of the OCC's review." Paragraph (b) does provide a helpful list of generally permissible antitakeover provisions.

However, while the OCC has concluded that the types of provisions set out in paragraph (b) are not inconsistent with Federal banking statutes and regulations in general, the specific provision a particular bank adopts may contain features that could change the result of the OCC's review at least as to those provisions not prohibited as inconsistent with the law pertaining to national banks. Proposed Section 7.2001 expressly discusses the following common antitakeover provisions under state law providing only general guidance but not legal validity to their enforceability except in those cases that the OCC believes the provision is unlawful for a national bank.

The types of antitakeover provisions listed in the NPR deemed generally permissible include: restrictions on combinations with interested shareholders, poison pills, requiring shareholder action to be taken at meeting, limits on shareholder authority to call a special meeting, and shareholder removal of directors only for cause. Restrictions on the right to vote shares above a certain percentage, and supermajority voting provisions are prescribed as prohibited for national banks but are provisions normally permitted for federal associations.

As many, if not most, national banks are controlled by state incorporated holding companies, it is doubtful that this proposal will have much of an effect on the practical use of protective charter and bylaw provisions. Since the holding company typically holds the controlling interest in the bank, any contest occurs at the holding company level. It is at this level that most corporate charters include protective provisions. Also, in view of the OCC prohibition on supermajority and percentage voting limitations, not to mention the various qualifications the proposal places on the use of antitakeover provisions commonly available at the holding company level, there is no danger of a rush to dismantle holding companies. It may be possible to deter certain predatory tactics by a bylaw or articles amendment at the bank level bypassing a shareholder vote at the holding company level, but it would still require a determination by the OCC that such a provision was valid.

Suffice to say, the NPR contains a wide range of subjects but banks and associations should be particularly focused on its governance provisions.