ARKANSAS COMMUNITY BANKER

Spring 2017

2017 Compliance Conference Sep 20-21

Page 21

published by

ARKANSAS COMMUNITY BANKERS ASSOCIATION

Dereliction of Duty

THE AUTHOR........

Daniel J. Beck, J.D., LL.M. (dbeck@qgtlaw.com) is an Associate with Quattlebaum, Grooms & Tull, an ACB Associate member.

BY DANIEL J. BECK

A bank's culture begins with its board of directors. Those individuals set the tone for the bank and have the ultimate responsibility for its successes and failures. Warren Buffet understood this in 1991 when he stepped in as Chairman to lead Salomon Brothers after the investment bank was close to filing bankruptcy for a bond trading scandal.

A few years earlier in 1987, Mr. Buffett made an investment on behalf of Berkshire Hathaway to become the largest shareholder of Salomon Brothers. In the wake of the scandal, Mr. Buffett had to testify in front of Congress. As part of his testimony, Mr. Buffet stated:

> I have asked every Salomon employee to be his or her own compliance officer. After they first obey all rules, I then want employees to ask themselves whether they are willing to have any contemplated act appear the next day on the front page of their local paper, to be read by their spouses, children, and friends, with the reporting done by an informed and critical reporter. If they follow this test, they need not fear my other message to them: Lose money for the firm, and I will be understanding; lose a shred of reputation for the firm, and I will be ruthless.

Now Mr. Buffett's Berkshire Hathaway is the single largest shareholder of another financial institution that is embroiled in scandal – Wells Fargo & Company.

Wells Fargo entered into a consent order with the CFPB on September 8, 2016 to pay the CFPB $100 million for its practices that included opening unauthorized deposit accounts for existing customers, issuing credit cards without their customers' knowledge, enrolling customers in online banking services that they did not request, and ordering and activating debit cards using customers' information without their knowledge. Wells Fargo also has to pay $35 million to the OCC and $50 million to the City of Los Angeles for its fraudulent behavior. While these fines are significant, considering Wells Fargo currently holds $1.9 trillion in assets, the harm to the company's reputation may have more of an impact than the fines.

As part of the fallout of the scandal, Wells Fargo eventually terminated its acting Chairman and CEO, John Stumpf and its Community Bank leader Carrie Tolstedt, who has received the bulk of the blame for the scandal. Both had to forfeit unvested awards and claw-back vested awards totaling $69 million for Stumpf and $67 million for Tolstedt.

In response to the CFPB consent order, the Board of Directors ordered an internal investigation into the sales practices of its Community Bank. The Sales Practices Investigation Report was created by the law firm Shearman & Sterling LLP and was released on April 10, 2017. The report largely blames Tolstedt as head of the

Community Bank and Wells Fargo's decentralized structure. Tolstedt, who was admired throughout the bank for her success with cross-selling, implemented a culture of high pressure sales wherein employees were constantly worried about making quotas just to keep their jobs.[1] The pressure created high turnover with inexperienced bankers being promoted largely due to their sales performance.[2] While the report does not absolve the Board, it is not highly critical and gives cover to the Board by highlighting that the sales practice and sales integrity issues were not flagged by top executives to the Board or any of its committees as "noteworthy risks" until 2014.[3] Essentially saying the Board was kept in the dark by the executives of the company. A closer look at the company's sales practices over more than a decade and one could see that the Board certainly had ample evidence that it should be concerned with the risks related to the company's sales practices.

Wells Fargo's most recent troubles arose out of a *Los Angeles Times* article in 2013, citing the company's high pressure sales requirements that lead to unscrupulous behavior, and ultimately to the City of Los Angeles challenging those practices in a lawsuit in 2015. But that was not the beginning of Wells Fargo's problems with its sales culture. As early as 2002 the Board's Audit & Examination Committee received warnings about the company's sales conduct and "gaming" issues.[4] However, no fundamental changes were made.[5] In 2010, there were 700 cases of whistleblower complaints about Wells Fargo's sales tactics, even though Wells Fargo's Board claimed they were never informed about the complaints.[6] In 2011, Wells Fargo entered into a consent order with the Federal Reserve Board which imposed an $85 million civil penalty based on allegations that internal compensation arrangements would encourage sales personnel to steer borrowers that qualified for prime mortgage into subprime products.[7] The following year in 2012, the Justice Department required Wells Fargo to pay $184.3 million in compensation to qualified minority borrowers steered into subprime loans.[8] The idea that the Board of Directors at Wells Fargo didn't know the risks surrounding sales practices prior to 2014 is hard to believe. Yet the internal investigation indicates that the lack of emphasis on the sales practice issues was understandable because such risks were not understood quantitatively to have a material impact on Wells Fargo's financial statements.[9] The Board seemed to be satisfied with management's actions of simply firing lower level employees and managers for misconduct, but not changing the culture until the company was embroiled in litigation.[10]

The board of directors for a bank "cannot delegate its responsibility for the consequences of unsound or imprudent policies and practices, whether they involve lending, investing, protecting against internal fraud, or any other banking activity."[11] It appears as if the Board for Wells Fargo is trying to "pass the buck" and has received serious criticism outside of Wells Fargo for the dereliction of the Board's duties. Two proxy firms announced their recommendation that many of the Directors for Wells Fargo should be dismissed prior to a vote on the election of the Board. Institutional Shareholder Services ("ISS") recommended twelve of the fifteen Directors be terminated, and Glass Lewis recommended that six be terminated. The Board has called ISS's recommendation "extreme", "unprecedented", and "unwarranted".[12] A majority of the shareholders of Wells Fargo agreed, and it has been reported that Berkshire Hathaway voted in favor of all the existing directors.[13]

Even though the Directors were re-elected, some narrowly, they will have to deal with the fallout from the company's over aggressive sales culture for some time. For example, a new shareholder lawsuit has been filed against Wells Fargo alleging the bank targeted undocumented immigrants by instructing employees to "round-up" undocumented immigrants at construction sites, factories, and 7-Elevens and drive them to a Wells Fargo branch to open unneeded accounts.[14] At 86, Mr. Buffett will not be stepping in to take over as chairman of the Board. However, the Directors should listen to his words from the Salomon Brothers crisis and let senior executives know that they should not only comply with the law, but use their moral compass. If any executive or employee causes the company to lose a shred of reputation, the Board's response should be, in Mr. Buffett's words, ruthless.

---

[1] Independent Directors of the Board of Wells Fargo & Company Sales Practices Investigation Report, pgs. 6-7 (Apr. 10, 2017).
[2] *Id.* at p. 28.
[3] *Id.* at p. 97.
[4] *Id.* at 98.
[5] Matt Egan, *Wells Fargo scandal: Where was the board?* (Apr. 24, 2017), http://money.cnn.com/2017/04/24/investing/wells-fargo-scandal-board-annual-meeting/.
[6] *Id.*
[7] Howell E. Jackson, *One Take on the Report of the Independent Directors of Wells Fargo: Vote the Bums Out*, (Apr. 22, 2017), https://corpgov.law.harvard.edu/2017/04/22/one-take-on-the-report-of-the-independent-directors-of-wells-fargo-vote-the-bums-out/.
[8] *Id.*
[9] Independent Directors of the Board of Wells Fargo & Company Sales Practices Investigation Report, pgs. 6-7, 14, 100.
[10] *Id.*, pgs. 32-33, 36-37, 105.
[11] Fed. Reserve Com. Bank Exam. Man., Section 5000.1, Duties and Responsibilities of Directors, p. 1 (Apr. 2013).
[12] Wells Fargo Board of Directors Issues Statement on ISS report (Apr. 23, 2017), https://wellsfargo.com/about/press/2017/statement-iss_0407/.
[13] John Maxfield, *Can Warren Buffett Save Wells Fargo's Board of Directors?* (Apr. 24, 2017), https://www.fool.com/investing/2017/04/24/can-warren-buffett-save-wells-fargos-board-of-dire.aspx.
[14] Nikita Biryukov, *Wells Fargo Account Scam Targeted Undocumented Immigrants, Lawsuit Claims* (Apr. 27, 2017), http://www.nbcnews.com/business/business-news/wells-fargo-account-scam-targeted-illegal-immigrants-claims-lawsuit-n752206.