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Locke Lord QuickStudy: Federal Reserve Board Order of Prohibition Sends Message to Departing Bank Executives That ?Actions to Poach Former Employer Data, Customers and Documents May Put Your Career at ?Risk

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The Federal Reserve Board recently issued a final decision *In the Matter of: Frank Smith and Mark Kiolbasa, Institution Affiliated Parties of Farmers State Bank,* Docket No. 18-036-E-1. The decision creates a significant precedent in expanding the range of state law violations of the fiduciary duty of loyalty from activities which involve a substantial loss to the loss of substantial business as grounds for an order of prohibition against an IAP. It serves as a major deterrent to those IAPs tempted to treat bank customer relationships as their own in considering soliciting business for their new employer before departing their current employer. The decision establishes a number of significant enforcement principles that extend beyond orders of prohibition to include the application of collateral estoppel on vacated court decisions as a result of a subsequent settlement and the long arm of agency jurisdiction so long as an IAP is employed at a member bank finding that concurrent jurisdiction is shared between the FRB and FDIC when an IAP who commits fiduciary wrongs at a nonmember bank changes employment to a member bank.

Both Smith and Kiolbasa ("executives") were Officers of Central Bank and Trust ("Central"), a Wyoming state non-member bank subject to FDIC regulation and a subsidiary of a FRB regulated holding company. Kiolbasa was chief loan officer and President and Smith was the CFO. Central maintained a strict privacy policy which stated the Bank's information, files and data were the sole property of the bank. It also had an employee handbook which stated the Bank's expectation of fiduciary loyalty detailing specific duties of loyalty. Both executives acknowledged their responsibility to abide by the policy.

The executives adopted a business plan in 2013 prescribing their interest in personally acquiring a major ownership interest in Farmers State Bank ("Farmers") and opening a loan production office in Central's market area with a goal acquiring millions of dollars in new loans. They discussed their plan to obtain commitments from Central's customers to transfer business to Farmers before they departed. The FRB decision detailed a series of actions which evidenced that the executives were actively soliciting business for Farmers from Central's customers while employed at Central. It also detailed various documents such as Central's lending forms and loan spreadsheets which the executives took with them to Farmers. The day after Kiolbasa tendered his resignation on September 11, 2014 which became effective 8 days later, Smith executed a letter of intent to purchase an interest in Farmers while remaining at Central. As early as two and a half weeks after leaving Central

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and for months thereafter, numerous Central loans moved to Farmers. Smith enabled Farmers to send payoff checks without going through the usual payoff request process at Central because he directly provided Kiolbasa with the payoff information necessary for the loans of several Central customers while still employed at Central. The decision also detailed several instances where the two strategized on business opportunities that benefited themselves or Famers at the expense of Central after Kiolbasa had departed but while Smith was still CFO at Central. In one instance Smith "talked down "a potential acquisition opportunity for Central because the executives may have had an interest in pursuing it for Farmers. Evidence was cited that Smith actually performed work for Farmers while still at Central. On March 6, 2015, the executives signed a stock purchase agreement to acquire a combined 27% interest in Farmers. When confronted by Central's management on March 18, 2015, Smith resigned and shortly thereafter became President and CEO of Farmers and a director.

In September of 2016, Central filed a civil lawsuit in Wyoming state court against their former executives claiming misappropriation of trade secrets, breach of fiduciary duty and tortious interference with contract or economic advantage. The suit went to a jury trial with the jury finding the executives liable awarding Central over a million dollars in damages and punitive damages for willful, wanton and malicious conduct. The final judgment was entered and the parties appealed. During the pendency of the appeals the parties entered into a global settlement after which the trail court vacated the judgment.

The FRB initiated a prohibition proceeding on December 11, 2018. The matter was heard by an ALJ under the APA who affirmed the order issuing a partial summary disposition on October 24, 2019 with the executives challenging the ALJ decision before the full Board. The first issue considered was whether the FRB could issue a prohibition order against IAPs for misconduct while employed at a state nonmember bank. The FRB cited the language of Section 8(e)(1) of the Federal Deposit Insurance Act ("FDI") which gives the FRB authority to issue an order of prohibition against any IAP who has committed acts which constitute grounds for prohibition **"in connection with any insured depository institution or business institution".** It went on to reject the executives' argument that the FDIC had exclusive jurisdiction over their actions while employed at a state nonmember bank and ruled the FRB shared concurrent jurisdiction with the FDIC where the IAPs formerly worked at a nonmember FDIC regulated bank but transitioned to a member bank.

The next issue addressed by the FRB was whether the executives were subject to the doctrine of collateral estoppel which the ALJ applied in his findings. The executives argued that the judgement in the Central litigation was vacated as part of the global settlement and thus the ALJ could not rely on the findings by the Wyoming court. The executives did not contest the use of collateral estoppel in agency proceedings in general. The ALJ found there was no controlling case law but relied on a Sixth Circuit opinion, *Watermark Senior Living Retirement Communities v Morrison Management Specialists, Inc*. FN 905 F.3d 421 (6th Cir. 2018). In *Watermark*, the court gave preclusive effect to a judgement that was vacated after settlement reasoning that to do otherwise would allow multiplicity of actions with conflicting judgments. It further distinguished vacatur pursuant to a post judgment settlement reasoning that "a party that elects to forego further review is not similarly situated to a party that won vacatur due to a finding that a ruling was faulty or lost a chance to appeal due to factors beyond its control." In applying the Sixth Circuit opinion, the FRB rejected the executives' contention that the 10th Circuit decisions were controlling determining that it was necessary to only predict how the Wyoming Supreme Court would rule. Interestingly, the FRB determined by prediction how the Wyoming Court would rule, affirming the preclusive effect of the pre settlement judgment. The FRB was unpersuaded by the argument that the executives did not have a full and fair opportunity to litigate since they could not anticipate they would be barred from their chosen profession

when they were defending claims for civil money damages. It noted the executives vigorously defended the litigation.

The FRB decision then explored the ALJ findings which were primarily based on the Wyoming court's vacated ruling. It first found that the executives engaged in multiple breaches of their fiduciary duties constituting misconduct under 12 USC 1818(e). It rejected executives' arguments that only conduct that has both a reasonably direct effect on an association's financial soundness and places an abnormal risk of financial loss or damage on a banking institution is unsafe or unsound. It affirmed the ALJ's holding that conduct "contrary to generally accepted standards of prudent operation the possible consequences of which, if continued would be abnormal risk or loss or damage to an institution" is an unsafe and unsound practice. This standard opens the vast realm of the possible rather than the probable a far cry from the reasonably direct effect standard argued by the executives. It introduces an equation between breaches of the duty of loyalty as tantamount to an unsafe and unsound practice while weakening the direct statutory nexus between loss and unsafe and unsound practices. This equation as applied in prior FRB decisions relies on whether a practice is expected to cause a bank damage whether or not it has a detrimental effect on the bank's overall condition. It may eliminates an inquiry into the degree of harm caused by misconduct suggesting difficulty arguing a materiality standard in defense of a claim that a practice is unsafe or unsound. The FRB stated its belief that Section 1818 requires a focus on the nature of the act rather than its effect on the bank. Indeed the FRB construes the penalty structure of the law as the relevant context for inquiries on matters of degree.

Based on the above reasoning the FRB reviewed the Wyoming trail court's ruling, the facts developed at the APA hearing, the ALJ's ruling based on those proceedings. It concluded that the executive's actions met the statutory standards for an order of prohibition. It found that there were sufficient facts to prove an improper act that had an impermissible effect and was accompanied by a culpable state of mind even without relying on the Wyoming trail court's findings.

This ruling is a based on particularly egregious facts but creates a precedent which will doubtlessly be relied on by banks who believe their departing executives have utilized bank property such as tangible documents, data and relationships to promote their own or new employer's interests. It could inject the FRB and other banking agencies into fiduciary misconduct disputes which are normally the province of state courts. The termination of a career in banking appears to be a draconian punishment of executives that have already settled a claim of wrongdoing with their former employer. It is particularly unusual when the imposition of such a penalty is by an agency that was not even the primary regulator of the bank that was the victim of the misconduct. One wonders if this is not the final chapter or will it move on to the courts particularly on the issue of preclusion in connection with post settlement vacated judgments an area of law which is yet unsettled among the Federal Circuits.

The lessons of this decision are that executives should be particularly careful in their conduct preceding departure from an employer to a competitor in understanding the distinction between their personal knowledge and experience and information which is the property of their soon to be former employer. Unfortunately, there is not always a bright line between the two. It would be prudent to consult with counsel prior to embarking on a major new venture that involves competition with a former employer.

Emotions often run high when key employees depart to a competitor and employers should not be incited to bring action or file regulatory complaints with every perceived infraction of the breach of loyalty. Employers should

consult with counsel on the application of covenants not to compete and confidentiality agreements as the standard prophylactic measure not the threat of regulatory action. Moreover, executives who become embroiled in employment litigation involving their duty of loyalty should be forewarned that any post judgment settlement may not preclude regulatory action based on vacated rulings. Ironically, the FRB decision as to preclusion may further burden the courts discouraging settlements that involve vacated judgments.

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