H.B. 192: A Statutory Solution for Director Decision-Making

The provisions of the Georgia Financial Institutions Code and the Business Corporations Code dealing with director liability must be amended to modernize them and make them competitive with the codes of other states.

In the vast majority of states, the business judgment rule protects both the decision-making process and the actual decisions of directors made in good faith from any second guessing by courts and juries. The only exceptions are where the directors are guilty of gross negligence, fraud or bad faith. In *FDIC v. Loudermilk*, however, the Georgia Supreme Court recently held that directors of Georgia banks and corporations could be liable for *ordinary negligence* committed in the decision-making process.

By allowing ordinary negligence claims to be brought against directors of Georgia banks and corporations, the Court has severely undercut the business judgment rule. The question of whether a bank or corporation has engaged in an appropriate decision-making process is now subject to second guessing by courts and juries – precisely the result that the business judgment rule was designed to eliminate.

This is exactly the situation in which former directors of Buckhead Community Bank recently found themselves in the *Loudermilk* case. There, the court allowed the jury to second guess the directors on whether the board employed an appropriate decision-making process in approving various commercial loans.

There are very strong policy reasons for keeping the decision-making process of directors beyond the review of the courts and juries except in cases of gross negligence, fraud or bad faith. First, banking regulators demand that bank directors be directly involved in certain critical bank decisions to ensure proper oversight. Second, if bank directors fear liability in making those decisions, they may act in a highly risk averse manner that does not benefit shareholders. Third, it is essential to good corporate governance that banks and other corporations be able to attract experienced and capable independent directors. The risk of being held liable for ordinary negligence in the board decision-making process is a powerful deterrent to board service.

The holding in *Loudermilk* has caused many legal practitioners to recommend to bank directors, and many bank directors to demand, that they only be involved in the highest level of decisions so that their decision-making process cannot be second guessed by courts and juries. Encouraging directors to be less involved in bank decisions may conflict with the direction given by many bank examiners and in many cases is bad for the banks themselves.

Another prime example of the problems created by *Loudermilk* is that many Georgia banks are now decreasing the roles of their loan committees, and some bank directors are requesting not to serve on the bank's loan committee. However, even institutions taking these actions need to be cognizant of the fact that the board is still obligated to ensure the proper operation of the credit function. Simply removing the directors from

the underwriting process could lead to process-oriented claims that would be judged pursuant to a simple negligence standard under *Loudermilk*.

In order to continue to build on Georgia's reputation as a favorable state in which to do business, Georgia must clarify the protections of a business judgment rule post-*Loudermilk*. Both the Financial Institutions Code and the Business Corporations Code need to be amended.

The proposed amendments track the work of the business law committee of the State Bar and should be passed for the following reasons:

1. As optimism builds toward an era of business expansion, we need to encourage businesses, particularly banks, to organize in Georgia. It is vital to the health of communities in Georgia that we encourage the formation of new Georgia banks. In the post Dodd-Frank era, it is no longer necessary for banks to incorporate in Georgia in order to have branches and to operate here. As a result, we need to be forward-thinking and inviting to new banks and use our best efforts to retain the existing state charters that we have by creating the best banking governance laws. Because most banks have holding companies that are governed by the Business Corporations Code, parallel changes are necessary there as well.

2. In the wake of *Loudermilk*, some practitioners are issuing strong cautions regarding serving as a director of a Georgia bank. While we view these concerns as overstated, this type of sentiment undercuts our ability to attract new banks. *Loudermilk* may also have a chilling effect on decisions being made at the Board level. If we want Georgia corporations to be guided by independent and sophisticated directors rather than exclusively by management or large shareholders, they must have the proper tools to confidently engage in decision-making.

3. Because the existing law under *Loudermilk* makes jury trials of claims against directors and officers much more likely, it is expected that there will be a commensurate increase in the cost of insurance for such claims. Modernizing the code would also be expected to help manage the cost of such insurance in the state.

4. Taking action at this time would continue to raise Georgia's profile as a favorable place in which to do business, and we believe that this year is an important year to do so given that confidence in business growth seems to be building.