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# FDIC Recovery Efforts Highlight D&O Insurance Issues

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The Federal Deposit Insurance Corporation's recovery efforts against the directors and officers of failed financial institutions raise numerous insurance issues that highlight the importance of negotiating favorable coverage terms before a serious claim arises.

The financial crisis that began in 2008 has resulted in an unprecedented number of failed financial institutions. As the receiver for those institutions, the Federal Deposit Insurance Corporation (FDIC) may sue professionals, including directors and officers, alleged to have played a role in the failure. In addition to these civil lawsuits, the FDIC has other recovery tools at its disposal, including the potential "clawback" of compensation from the directors and officers of the failed institutions.

Together, these recovery efforts raise numerous directors and officers (D&O) liability insurance issues that will determine the insurance protection available to individuals pursued by the FDIC. More generally, these issues highlight the importance of negotiating terms favorable to directors and officers, whether in the financial industry or elsewhere, at the time of policy placement or renewal, *before* a serious claim arises. D&O insurance policy forms, perhaps more than any other line of insurance, vary by insurer and usually are subject to negotiation.

## Professional Liability Lawsuits on the Rise

As of August 2011, the FDIC had initiated suits in connection with 11 failed institutions against 77 individuals. Other suits have been authorized but not yet filed, involving a total of 30 failed institutions against 266 individuals. The FDIC decides whether to pursue litigation upon completing an investigation into the causes of the institution's failure; these investigations can take up to 18 months from the time the FDIC closes the institution. Consequently, it appears likely that the FDIC will authorize even more suits against the directors and officers of institutions that failed during the recent financial crisis.

The FDIC's suits typically allege negligence, gross negligence, breach of fiduciary duty and failure to supervise. In particular, the FDIC often alleges that directors and officers failed to exercise appropriate business judgment in approving risky strategies, ignoring underwriting and investment guidelines, and generally being “asleep at the wheel” as their institution lurched toward insolvency.

**New Compensation Clawback Rules**

In addition to civil litigation, the FDIC can pursue through other channels directors and officers allegedly involved in the failure of a financial institution. Pursuant to the Dodd-Frank Act, the FDIC recently adopted final rules allowing the FDIC to “claw back” compensation earned by directors and officers during the two years preceding the FDIC’s appointment as the receiver of the failed institution. “Compensation” is defined broadly to include salary, bonus, severance pay, benefits and stock options, among other items.

The clawback is warranted if directors and officers deemed “substantially responsible” for the failure did not conduct their responsibilities with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances—a negligence standard. The FDIC need not prove more culpable conduct, such as gross negligence or fraud, in order to recover. When added to the exposure from civil lawsuits, these clawback rules create a significant financial risk to officers and directors.

**D&O Insurance Coverage Issues**

D&O insurance coverage for the individual defendants at failed institutions likely will turn on a small number of key issues. In particular, two policy exclusions may come into play.

The “insured v. insured” exclusion is found in virtually all D&O policies that cover both the individuals and the financial institution (commonly referred to as a Side A/B/C policy). The insurance industry developed this exclusion in the aftermath of the savings and loan (S&L) crisis of the 1980s, when numerous S&Ls attempted to convert their policies into cash by suing their own directors and officers. The exclusion bars coverage for most claims brought by one insured (either the company or an individual director or officer) against another. Many courts have applied the exclusion where a trustee or receiver sues an individual director or officer on behalf of the institution.

Unless the policy “carves out” claims by receivers such as the FDIC from the exclusion, or deletes the exclusion altogether—both options that can be obtained in the insurance markets—coverage for the FDIC’s claim may be barred.

A less common, but potentially relevant exclusion is the “regulatory exclusion.”  The exclusion may bar coverage generally for claims brought by any governmental, quasi-governmental or regulatory entity, or it may be worded to target particular agencies such as the FDIC.  This exclusion also came into wide use in the aftermath of the S&L crisis, but as the insurance industry’s memory of that crisis faded it became less common. Several commentators have suggested that since the beginning of the financial crisis in 2008 this trend has reversed, however, as insurers are seeking to insert the exclusion into D&O policies sold to financial institutions.  If the exclusion is at the center of coverage disputes going forward, insureds will face an uphill battle, as the vast majority of courts to consider the regulatory exclusion found it enforceable and applied it to bar coverage for claims brought by government agencies.  Only a small number of courts rejected the exclusion on grounds of public policy or ambiguity of a particular policy form.

Finally, the FDIC’s clawback rules raise other insurance coverage questions.  Most significant is whether the return of compensation can be characterized as restitution, such that it does not constitute insurable “loss” under basis insurance principles. Moreover, if the compensation clawback is considered “profit, remuneration or advantage to which the Insured was not legally entitled,” then it would be excluded from coverage under the typical D&O policy.

**Obtain Favorable Policy Terms**

For those directors and officers already facing FDIC recovery efforts, it may be too late to obtain more favorable D&O policy terms that will preserve the insurance protection they need.  But for many others, the opportunity to review and improve their D&O coverage still exists.  According to the FDIC, 865 banks (more than 11 percent of ongoing institutions) are identified as “problem institutions” as a result of “financial, operational, or managerial weaknesses that threaten their continued financial viability.” These institutions are not yet the subject of FDIC action, and their directors and officers should check the terms and conditions of their D&O insurance to mitigate the risk that any of the coverage issues discussed herein could threaten their coverage.

If the coverage is less than adequate, directors and officers should attempt to negotiate more favorable terms. In particular, most insurers will “carve out” from the insured v. insured exclusion claims by receivers such as the FDIC, thereby eliminating this key obstacle to coverage. While the language of the regulatory exclusion may not be subject to negotiation, it may be possible to omit it from the policy altogether. Perhaps the most effective way to ensure coverage exists for an FDIC claim is to obtain a separate Side A or personal director’s liability policy. Both of these policies cover only the individual, not the institution, and afford broad coverage compared to the typical Side A/B/C policy. Among their many positive attributes is the omission of the insured v. insured and regulatory exclusions.

Finally, the insurance industry’s response to the Dodd-Frank Act generally, and the FDIC clawback rules specifically, continues to evolve, affording new coverage options. A new endorsement is now available that indemnifies an individual officer or director for compensation returned pursuant to the clawback rules. Other endorsements cover the cost of defending against an FDIC action, but do not indemnify for returned compensation. Because all of these products are relatively new and not yet incorporated in standard D&O policy forms, directors and officers should inquire specifically about them to their company’s risk manager or insurance broker.

These measures—reviewing existing policy forms with an insurance broker and insurance counsel, negotiating more favorable terms and conditions where possible and exploring a separate Side A or personal director’s liability policy—should afford officers and directors of financial institutions with the best available D&O insurance protection should an FDIC claim arise. They also may benefit directors and officers at companies outside the financial industry who are looking to confirm that D&O insurance will be there when they need it.