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D&O INSURANCE: AVOIDING TRAPS AND KEEPING COVERAGE IN A DISTRESSED BANKING ENVIRONMENT

ROBERT P. SIELAND AND CRAIG E. GOESEL

The authors explore the many forms of "D&O insurance failure," and then discuss steps that can be taken proactively to avoid gaps in coverage by planning for renewals, obtaining "tail" coverage and filing "notices of circumstances" with insurers when receivership or bankruptcy is inevitable.

D&O policies often can sit on a shelf collecting dust, and their treasures or tragedies will be only uncovered when a lawsuit is filed against directors and officers. At that point, it may be too late to remediate the holes in the policy. When the directors and officers learn that the hefty premiums their company had been paying bought a sieve, not a shield, their normal deep concern about an impending lawsuit can quickly become justifiable anxiety. This is D&O insurance failure.

Banks, their holding companies and their directors and officers are getting sued in the current distressed banking environment. Lawsuits and threats of lawsuits can come from a variety of stakeholders — stockholders, bondhold-

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ers, other creditors and, if the bank fails, the FDIC. Understanding how the bank's D&O policy works before claims are threatened or filed has value because there are things a bank can do to plug holes in the policy, improve coverage and manage litigation risk in light of the scope of insurance coverage under contract. But none of this risk mitigation or director-expectations-management is possible if the policy is collecting dust on the shelf.

This article explores the many forms of D&O insurance failure. First, this article revisits the basics of D&O insurance and discusses some coverage points that often prove critical when claims are made. Then, this article discusses steps that can be taken proactively to avoid gaps in coverage by planning for renewals, obtaining "tail" coverage and filing "notices of circumstances" with insurers when receivership or bankruptcy is inevitable.

A RECOMMENDATION FOR ACTION — KNOWLEDGE AND UNDERSTANDING INFORM DECISIONS

This article's principal recommendation is to review your D&O policy now for gaps in coverage, quality of coverage and all the nuances in coverage that arise when a director or officer of a financial institution faces a threatened or pending lawsuit. That analysis should be reviewed promptly with the board of directors so the full board understands how the coverage works under a variety of realistic litigation scenarios and the board can then reach a fully informed determination on changes in coverage. Educating the board now will be an important first step in managing their expectations for coverage later should threats of a lawsuit arise or especially if the bank risks receivership.

OBTAINING COMPLETE D&O COVERAGE

Revisiting the Basics

What is D&O Insurance?

D&O insurance provides coverage against claims arising from "Management Practices Acts," which are typically defined as: (a) any error, misstatement, misleading statement, act, omission, neglect or breach of duty actually or allegedly committed or attempted by directors, officers, and in some policies, employees (such persons being "Insureds" under the policies), in their capacity as such or (b) any matter claimed against Insureds by reason of their service as a director, officer or employee of the company. The most basic D&O insurance coverage includes so-called "Side B" coverage, which covers companies for the costs of indemnifying their directors and officers against claims arising from Management Practices Acts, and "Side C" coverage, which covers the companies which Insureds serve against securities claims arising from Management Practices Acts. Basic D&O insurance also includes "Side A" coverage, discussed further below, which covers the individual Insureds directly for claims that are not indemnified by their companies. Additional limits associated with Side A coverage may be purchased in addition to the Side A provided under basic D&O insurance policies.

Side B coverage works this way, very simply. If the bank or its holding company indemnifies a director or officer against legal expenses and damages resulting from a lawsuit (that is, the bank or the holding company pays those costs for the director or officer's benefit), the bank or the holding company can then lay claim against the D & O policy for reimbursement of those monies. In this way, the bank and the holding company's indemnification provisions, which are often found in the charter or bylaws of the company as well as applicable corporate or banking statutes, work in tandem with the D & O policy. Accordingly, a review of the bank's D & O policy, logically, should be done in conjunction with a review of the scope of the bank and holding company indemnification provisions.

Obtaining Complete Coverage — A Primer

While the definition of a "Management Practices Act" seemingly covers the whole universe of possible acts by Insureds, D&O insurance policies typically do not cover certain *specific* liabilities, such as claims of wrongful termination, claims alleging a breach of duty as a trustee, or claims arising from lending practices or other banking services In order to have complete coverage, financial institutions and their directors, officers and employees should obtain specific professional liability insurance policies covering liabilities otherwise excluded from the coverage of D&O insurance policies. Such professional liability policies often provide coverage for claims that may arise against a company or its directors, officers or employees regardless of the performance of the financial institution itself. Banks and other financial institutions should typically obtain:

- *Employment Practices Liability Insurance*, providing coverage against claims of discrimination, harassment, breach of employment contract, wrongful termination and other employment-based claims;
- *Fiduciary Liability Insurance*, providing coverage to individuals serving as fiduciaries of employee benefits plans;
- *Trust Liability Insurance*, providing coverage to individuals acting in their capacity as trustees, custodians, personal representative, guardians, executors or other fiduciary roles;
- *Financial Institutions Bond*, covering a company's losses arising from an employee's dishonesty or fraud, or from an unassociated party's fraud, forgery or theft;
- *Bankers Professional Liability Insurance*, providing coverage against claims arising from an insured's granting or refusal to grant any loan, lease or extension of credit and the servicing, restructuring, transfer, repossession or foreclosure of such loan, lease or extension of credit; and
- *Privacy and Security Liability Insurance*, providing coverage against claims arising from a company's failure to safeguard personal information or from a wrongful release of private data or information.

While the foregoing policies are critical, the coverage they provide protects against liabilities arising in the ordinary course of business. By contrast, D&O insurance protects against liabilities arising from executive and board decisions being second-guessed by third parties. Such second-guessing is especially common in the context of failed companies, where investors and other interested parties — such as the FDIC — seek a partial recovery from their loss. In such circumstances, the financial ability of a company to indemnify its directors and officers is limited, and comprehensive D&O coverage is critical.

Side A Coverage

Side A coverage is a critical component of any directors and officers liability insurance policy. As discussed above, company indemnification coverage, so-called "Side B" coverage, only reimburses the *corporation* for costs arising from the acts of its directors and officers. However, if the company is unable to indemnify its directors and officers, then Side A coverage would step in to insure the individual directors directly for any personal liability they may face.

Reasons for Side A Coverage

Relying on a corporation as a sole source for indemnification, even when such indemnification is backstopped by Side B coverage, has two very important limitations.

First, when corporations become bankrupt or are put into receivership, funds from Side B coverage intended to fund a corporation's indemnification of its directors and officers may be claimed as property of the bankruptcy estate or receiver. Directors and officers seeking indemnity from their bank or company may thus find themselves as unsecured creditors of failed corporations with little chance of receiving payment from such corporation, even if the source of funds is from Side B coverage.

Second, corporations are prohibited from indemnifying directors and officers against certain claims otherwise covered by Side A coverage. Under Delaware law, while a corporation may indemnify its directors and officers against *direct* claims made by third parties arising from actions taken by a director and officer and believed to be in the best interests of a corporation, it may *not* indemnify against judgments arising from *derivative* actions whereby shareholders force the corporation to sue its director or officer on their behalf. Nothing prohibits a corporation, however, from obtaining insurance coverage for such derivative liability for its directors and officers in the form of Side A coverage.

Priority of Coverage and Protecting D&O Policies from Receivers and Bankruptcy Trustees

Side A policies are frequently included as part of a company's overall D&O insurance policy, and therefore subject to the overall coverage limits of D&O policies. As a result, such Side A policies often share the D&O insurance program's overall coverage limit. Directors and officers may find such policies of little use if claims are also asserted by third parties, such as the bankruptcy estate or receiver of their company, against the Side C entity coverage included in the general D&O insurance program. To avoid the exhaustion of the policy's coverage limits by claims made directly against the company, directors and officers should be sure their D&O insurance policy has a so-called "Order of Priority Endorsement," which provides that non-indemnified claims against directors and officers will be paid prior to all other claims.

Ensuring Complete Side A Coverage

Even with an "Order of Priority Endorsement," directors and officers may find their coverage limits are too low to cover all defense costs and judgments. Directors and officers should ensure that the amount of their Side A coverage is sufficient. Directors and officers should consider obtaining various backstop policies that serve as umbrella or excess policies when primary Side A coverage proves insufficient, due to exclusions asserted by the insurer (as discussed below), the refusal of a director or officer's company to indemnify, or costs exceeding the coverage limit. Examples are "Side A Only," "Side A Excess Difference in Conditions," and "Side A Independent Director Liability" policies. Because such policies are also separate from general D&O policies and run directly to the benefit of directors and officers, their proceeds cannot be claimed by a bankruptcy estate or receiver.

Duty to Defend

Even with Side A coverage, if an insurance policy does not obligate the insurer to *defend* the insureds against claims, directors and officers might face the prospect of an insurer refusing to advance defense costs, advancing less than all actual defense costs incurred or only providing coverage after such director or officer prevails in defending its claim. A "duty to defend" policy requires the insurer to defend the directors, officers and/or company for any claim that is *potentially covered* pursuant to the provisions of the policy. This means that any doubt about coverage is resolved in favor of the policyholder and the insurer must pay for the defense of the claim. A non-duty to defend policy obligates the insurer to reimburse its insureds for only *covered* costs (including defense expenses). Thus, an insurer might contend that a particular claim is not covered and refuse to pay the insured's costs of defense until the insured prevails or a court rules that the exclusion does not apply. Some companies purchase D&O policies without such duty to defend provisions in order to obtain a lower insurance premium. By doing so, however, they deny their directors and officers much of the peace-of-mind a D&O policy should provide. Litigation costs in most cases will be significant, and finding the resources to fund such litigation to a successful outcome could severely strain the finances of, or even bankrupt, any officer or director.

An insurer's willingness to advance litigation expenses often depends on the circumstances. If an insured company is financially healthy and generally has a low risk profile, an insurer will likely advance litigation costs as a routine matter. On the other hand, if an insurer views a company as a high risk, where the coverage costs will likely exceed premiums, insurers are more likely to contend that the policy does not require them to advance litigation costs. In these instances, insurers might take the position that certain claims or certain categories of defense costs are not covered expenses. When an insured's policy has a "duty to defend" requirement, however, the insurer's obligation to pay all defense costs — even for claims that, if proven, would not be indemnifiable — is unqualified. If *any* claim asserted by a third party among a myriad of claims is covered, the insurer must cover *all* claims. Moreover, such coverage covers *all* defense costs, not merely "covered" costs.

Directors and officers might reason that they do not wish to pay the added insurance premium because they assume that, faced with a lawsuit, they would want counsel of their own choosing, not counsel chosen by their insurer. Without "duty to defend" coverage elected, however, the companies and their directors and officers will have little leverage to demand any advancement of funds to pay for a defense. Should insurers find grounds to deny coverage or the advancement of defense costs, however weak such grounds may be, directors and officers, or their companies, will have to sue their insurers for coverage. Moreover, insurers in most instances accept their duty to defend with reservations. Under most state laws, such reservations would trigger a right to independent counsel of the insured's choosing, thereby usually mitigating choice of counsel concerns. To obtain contractual certainty regarding choice of counsel, insurance brokers can often obtain endorsements to address concerns with regard to the selection of counsel, while still obtaining the comfort of a "duty to defend" requirement.

Key Exclusions

Particularly problematic for directors and officers of failing financial institutions these days are the following common D&O exclusions that, if present, preclude certain otherwise indemnifiable claims from coverage.

Insured Versus Insured Exclusion

Insurance policies typically exclude from coverage claims between two of the insured parties under the same policy. The purpose of this exclusion is to preclude the company or directors and officers of such company from recovering from a lawsuit initiated by such persons. However, in the case of lawsuits filed by a bankruptcy trustee, or the FDIC as a receiver, against directors or officers, the trustee or receiver is acting in the company's stead — thus potentially triggering the insured versus insured exclusion. Directors and officers should be mindful that their D&O policy might not provide any coverage against claims by bankruptcy trustees or receivers if the exclusion is asserted, and future policies should include a carve-out from the insured versus insured exclusion for claims made by bankruptcy trustees or receivers.

Regulatory Exclusion

Of equal impact as the insured versus insured exclusion is the regulatory exclusion, which excludes from coverage enforcement actions brought by regulatory agencies. Such exclusions, which were common following the Savings and Loan Crisis and less common in recent years, have since appeared. The regulatory exclusion may preclude from coverage claims by the FDIC or other regulators against directors and officers. Directors and officers of financial institutions, in particular, should be mindful of this exclusion and seek to avoid its inclusion in future policies.

Full Severability Provision

Directors and officers should ensure that coverage provided to them is severable to that provided to other insureds. Without such a provision, an insurer may seek to deny coverage to all insureds on the basis of an exclusion applicable to only certain insureds or seek to rescind coverage entirely on the basis of any inaccuracies in the policy application that were not known to all insureds.

Benefits of Tailored D&O Policies

The foregoing summarizes just some of the basic coverage issues with D&O insurance these days. Clearly, one size does not fit all in the realm of D&O insurance — particularly when the insureds are financial institutions and their directors and officers. Companies and their officers and directors often find generic D&O policies of little comfort when they are needed and more carefully reviewed. With appropriate selection of experienced and trusted insurers and careful vetting and negotiation of key provisions in D&O policies, companies and their directors and officers can avoid coverage disputes in the future.

OPTIONS FOR MAINTAINING D&O INSURANCE COVERAGE

In light of today's troubled banking environment, D&O insurers are eager to jettison risky insurance policies. As a result, directors and officers of banks cannot sit idly in today's environment, assuming that their last defense against personal liability — D&O Insurance—will always be in place to continue to provide reliable coverage. Proactive steps, dependant on the health of the bank, are necessary to maintain that coverage of potential claims.

Renewal Process

Unlike the past ten years, the past 24 months had been marked by unusually difficult renewal cycles due — not coincidentally — to the challenges the banking industry is currently facing. In the past, a community bank may have been able to use the services of a *generalist* insurance agent (i.e. an insurance agent with general product knowledge with no specific industry or product line focus). These relationships were usually adequate as the insurance carriers often put their best foot forward in offering terms and bids on the insurance program.

In light of the many bank failures over the past 24 months, and the anticipated FDIC activity in the next 12 months, insurers are no longer offering easy renewals and need to be kept engaged in the process and tethered to their policyholders. The following guidelines offer suggestions about how best to utilize the time available to secure the most favorable renewal terms and avoid potential gaps in coverage.

First, work with an insurance broker who not only serves the company (as opposed to its insurance carriers) first and foremost, but also has the experience and expertise to effectively negotiate with the insurance marketplace. Keep in mind that quality brokers with expertise in management liability and financial institutions have normally worked with the same insurers on a number of different occasions. Because of this, they may anticipate typical responses or concerns that the respective insurers may have with regard to banking institutions. Generalist agents may have a solid understanding of workers comp markets and CGL rates. But if they only have one or two banks in their client stable, they cannot possibly know the key coverage provisions being negotiated in the insurance marketplace.

Second, confirm that the insurer is financially stable and committed to supporting this coverage line for banking institutions. Unfortunately, insurance companies are not immune to the same economic conditions negatively affecting banks. Many insurers have been downgraded by the ratings bodies, and others have been sold or merged. In addition, certain insurers have all but abandoned writing D&O insurance for community banks. It is best to know upfront if your incumbent insurer is even worthy of consideration before precious time and energy is spent seeking a renewal from an incumbent insurer on favorable terms.

Engaging the insurance carrier in the renewal process is more important than ever before. Instead of completing an application and allowing the broker to secure options on your behalf, take a more personalized approach. Meet with your insurer as early as possible — preferably in person, but at least on a conference call. Whether this meeting is three months in advance of the D&O policy's expiration date or six months, it is a good idea to meet with your D&O insurance carrier to give them an update on your position and try to gauge its interest in your renewal. Finding an alternative insurer in this market can take time.

In developing the renewal submission, insurance carriers will be looking for the typical information: completed renewal application, copies of the latest financial statements and any open litigation or litigation logs. In addition, insurers will request copies of any regulatory orders and management's response, if applicable. As some of the information disclosed may not be publicly available, you should secure a non-disclosure agreement from the insurance carriers you will be approaching for coverage.

Upon providing this "hard data," bank management should actively seek to meet with its D&O carriers to discuss its circumstances. In this marketplace, it is all too often that an insurer will see the various financial ratios of a client and provide a firm "not interested" as a response. If an insurer is given the opportunity (or pushed) to have a meeting with bank management, you can initiate healthy dialogue about the bank's improved lending practices, foreclosure processes, capital raise discussions, and relationship with the regulators — points that cannot be ascertained from the application.

Rates on this line of coverage have been steadily increasing, and retentions and limits of liability have been unilaterally adjusted by the insurance carriers as well. These may be items that a bank will need to accept as realities of the new D&O marketplace.

On the other hand, banks should carefully scrutinize proposed renewal policies for exclusions discussed in the first part of this article. Insurers have become notorious for including exclusions, or offering reduced coverage that at first blush seems like a good bargain, that drastically limit the scope of D&O coverage. Banks should consult with their counsel to assess the appropriate level of coverage and ferret out hidden traps, while working with seasoned D&O brokers representing financial services firms to negotiate optimal renewals. Experienced D&O brokers will be aware of certain leverage points — such as the threat of exercising a tail provision of an incumbent insurance program (discussed further below), leaving an insurer with ongoing exposure but no continuing business.

Tail Provisions

Unfortunately, even banks with seemingly bulletproof D&O policies that have been thoroughly vetted by management, counsel and knowledgeable D&O insurance brokers might face the prospect of gaps in coverage requiring the exercise of the extended reporting period or "tail" of their existing policy. Such gaps commonly arise under two circumstances with distressed banks. Incumbent insurers may be motivated to refuse to renew a D&O policy, or offer renewal terms that drastically limit the value of the policy, because they view the likelihood of claims as too high. Alternatively, the coverage term of existing policies is cut short in the event the insured bank's assets are sold in an FDIC-assisted transaction and the "change of control" provision in the existing D&O policy is triggered.

Directors and officers facing the prospect of a termination of coverage need to consider so-called "tail" coverage in order to continue coverage for claims that (1) are made against the insured after the termination of the policy or the end of the policy period and (2) arise from events that occurred before the termination of the policy or the end of policy period. Even if a distressed bank obtains a new policy from a new insurer, the policy may only cover claims based on events arising after the start of the policy, and directors and officers without tail coverage under the old policy will be uninsured for claims arising from events that occurred before the end of the old policy period that do not result in actual claims against the insured until after the old policy expires.

What Does Your Tail Provision Provide? A Note of Caution

In most instances the tail provision provides an additional period of time (often limited to one, three or six years) in which the insured can report claims which arise from conduct that transpired while insured with the expiring (incumbent) insurance company. The exercise of a tail option is not an extension of current coverage, but instead an additional, extended reporting period in which to report claims for wrongful acts that occurred prior to policy termination.

Some policies, however, provide an elusive tail option. While providing an additional extended reporting period, the provision does *not* cover claims that are received *during* the tail period because the general nature of the underlying policy — a "claims made policy," covering claims received only during the policy period, not the extended reporting period — is unaltered. Insureds who think they have a contractual right to comprehensive tail coverage in such instances may find the actual benefits offered by their extended reporting period of limited value. When planning for a D&O policy renewal and assessing the adequacy of current D&O coverage, banks and their officers and directors should closely review the tail coverage offered by their insurer in the renewal policy and ensure such provisions provide comprehensive tail coverage.

Exercising the Tail

Tail provisions under D&O policies vary as to the period of time during which an insured company may exercise a tail. In all events, however, if a bank is facing receivership, it is critical that the tail provision be exercised *before* any (anticipated) regulatory takeover in order to ensure that the tail insurance is fully paid and not subject to approval by the regulatory body. Such fully paid policies are also non-cancelable in most cases.

Final Options — Providing a Carrier with Notice of Claims and Notices of Circumstances

D&O policies typically have very specific requirements for providing an insurance carrier with notice of claims. Failure to comply with these requirements *will* result in a denial of coverage by an insurance carrier. Providing adequate notice of an actual lawsuit, however, is relatively straightforward.

Providing notice to an insurance carrier of a *potential* lawsuit — through a notice of circumstances — is another matter. Banks may rightly assume that, in light of a perceived death spiral and looming receivership, shareholder and creditor lawsuits and, perhaps, regulatory actions will be inevitable. While the threat of such a claim is no doubt real, there is likely little to be gained from unnecessarily spooking a bank's D&O insurer. Any notice of such potential claims will be insufficient under the requirements of most D&O policies and potentially cause the insurer to seek grounds for cancellation or to not renew a policy because of a misrepresentation of fact. On the other hand, banks must strive to be truthful in their disclosures to insurers so as not to jeopardize their relationship with insurer or give the insurance carrier grounds for cancellation of the D&O policy because of a misrepresentation of fact. As the likelihood of a bank failure increases, however, the risk analysis may shift in the other direction. The potential upside of preserving an insurable claim by providing an incomplete notice of circumstances, however unlikely that may be to result in coverage, may outweigh the risk of losing continuing coverage when such coverage may inevitably terminate.

Banks in distress should consult with their counsel and experienced brokers to weigh the advantages and disadvantages of providing a notice of circumstances to their D&O insurer. Naturally, counsel called to advise on whether a bank should provide a notice of circumstances to its D&O insurer will need to have a deep understanding of the regulatory dynamics, the bank's strategic options and capabilities for execution. As a result, counsel deeply immersed in assisting with such bank regulatory and other pressing issues are the ideal candidates for such an engagement.

Proactive Engagement with Insurers and Enlisting Experienced Advisors

In these tumultuous times, it is critical for directors and officers of financial institutions to be mindful of their D&O coverage and take proactive steps to ensure continued coverage and avoid gaps. Proactive directors and officers must regularly reevaluate their D&O needs and consider the availability of continuing coverage. Directors and officers should be prepared for surprises, and think strategically to avoid losing the confidence of incumbent insurers without unnecessarily jeopardizing continuing coverage. Early on, directors and officers should enlist experienced counsel and insurance brokers with particular expertise in financial institutions to develop a deep understanding of their particular business and the regulatory issues which may lead to insurance claims. With the assistance of such informed advisors, directors and officers will be able to weigh competing considerations and maximize leverage when negotiating policy renewals or otherwise seeking gap coverage.