

## GONE, BUT NOT FORGOTTEN: LINGERING RISKS THAT OUTLIVE OUR BANKS

The FDIC announced on May 24 that nearly 12% of the banks in the U.S. are on the problem bank list, with the most recent count reaching an all time high of 888 banks.

In fact, almost half of U.S. banks in existence 20 years ago are gone. These banks have vanished through a combination of healthy consolidation, mismanagement and, in some cases, fraud. Despite the launching of de novo institutions, the number of banks has fallen every year for the last two decades – and the pace is accelerating.

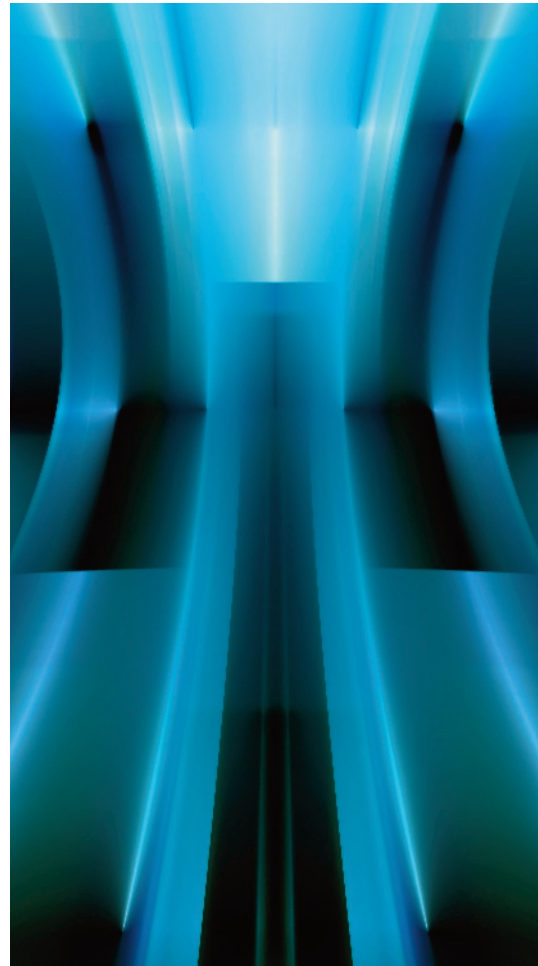
While the banks have disappeared, the grim reality for management is that the potential liabilities have not. In a move that likely sent chills up the spine of any former director or officer of a failed bank, the FDIC has commenced litigation against management of failed banks seeking to recoup its recent losses.<sup>1</sup>

The FDIC has authorized potential actions against 130 former directors and officers of failed banks seeking damages totaling \$2.6 billion. To date, it has actually launched seven suits naming more than 50 former D&Os, as well as two of their spouses. The causes of action include negligence, gross negligence and breach of fiduciary duty. The suits are based upon allegations of management ignoring signs of the market downturn and attempts to pad their own pockets by authorizing bad loans.

These concerns highlight several areas of Directors & Officers Liability coverage (D&O policy) that must not be overlooked, including the need for run-off coverage and ensuring that appropriate investigative and regulatory coverage is in place.

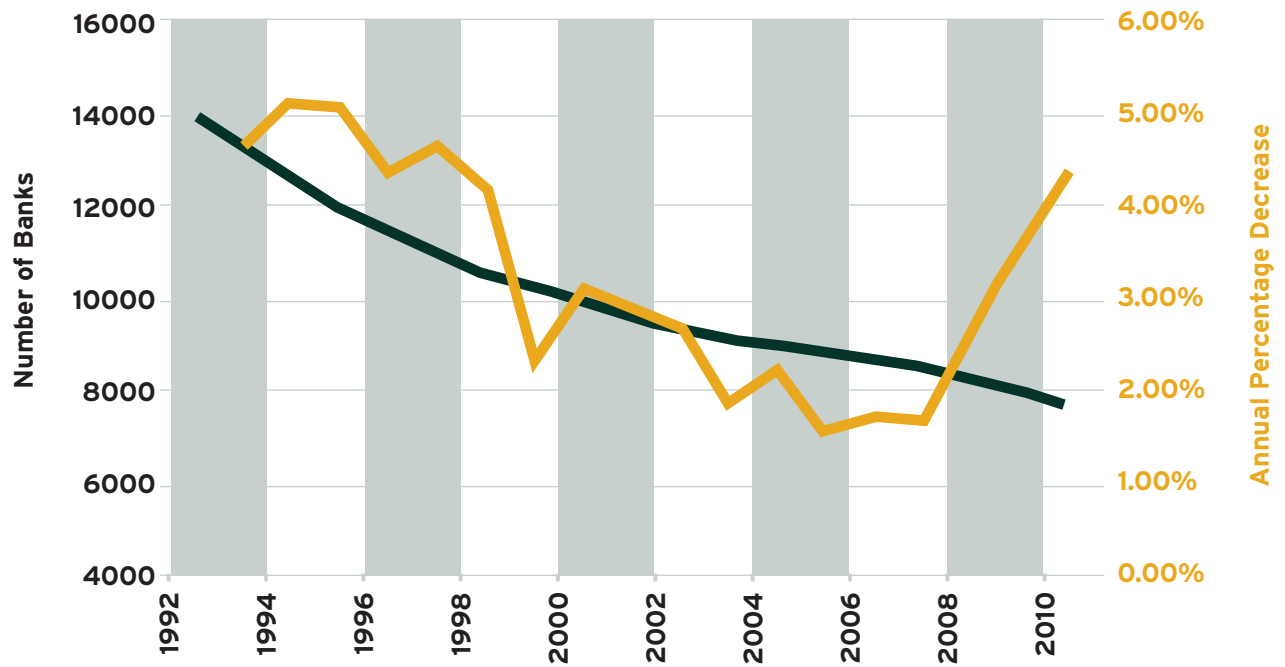
### **RUN-OFF COVERAGE**

In a merger, sale of assets or bank failure, one of the critical issues that a bank must address is the run-off insurance for the directors and officers, or future insurance coverage for their past acts and decisions.



Run-off insurance, sometimes called “tail insurance,” extends the reporting period of a policy for a specific number of years. In the case of a D&O policy, the run-off will cover claims arising from alleged wrongful acts of the directors and officers of the entity prior to the acquisition or failure. It is usually written as an endorsement to an existing D&O policy, but it also may be in the form of a policy newly issued by another insurer. Unlike a typical D&O policy which is only written for a single year, the run-off policy usually has a term to cover the longest potential statute of limitations; in most cases this is six years, but other options can be explored.

## NUMBER OF US BANKS AND ANNUAL PERCENTAGE DECREASE <sup>2</sup>



## WHY DOES A BANK NEED RUN-OFF?

D&O policies generally provide “claims-made” insurance that only covers lawsuits brought or made against management during the term of the insurance contract and before the expiration date of the bank’s existing policy. Failing to purchase run-off coverage after a bank has ceased to operate would leave directors and officers exposed without coverage for claims filed after the policy expires. This includes fraud claims, which, under Sarbanes-Oxley, may be filed by stockholders up to five years after the fraud was allegedly committed.

Moreover, if there is a change in control at the bank during the policy (turnover in the majority of the board, shift in controlling shareholders, etc.) the conversion to run-off mode is accelerated and, for the remainder of the existing policy, there is no coverage for any acts and decisions after the transaction date. The policy will only apply to new claims alleging wrongful acts occurring prior to the change in control.

## WHAT SHOULD MANAGEMENT DO?

For the same reasons senior management wanted D&O insurance when employed by the institution, they will want D&O insurance after its acquisition or demise to cover subsequent claims for past wrongful acts. If the corporate event can be anticipated, run-off coverage can be pre-negotiated and paid for so that it will take effect upon the date of the event.

If a bank’s demise is imminent, then D&O run-off coverage can be negotiated on the spot, either with one’s existing insurers or with new markets. The critical element is to not allow on-going coverage to lapse, as such gaps can be difficult (or impossible) to fill at a later time.

## REGULATORY COVERAGE

Given the heightened scrutiny from all regulatory authorities and the actively litigious stance of the FDIC, bank management is well advised to examine what degree of regulatory coverage is in place. Underwriters have sought to impose exclusions against regulatory investigations and any actions by the FDIC (civil or criminal). In some extreme cases, the carriers will attempt to impose a prior acts exclusion, which acts as a complete bar against coverage for any wrongful acts occurring before a date certain. These underwriter actions will result in a significant loss of protection afforded to management and may result in directors and officers paying losses out of their own pockets. In addition, the Dodd-Frank Act has empowered the FDIC with the authority to seek clawbacks of individual directors and officers' wages and bonuses in certain circumstances. Carriers are offering protection against these type of losses as well as other personal exposures faced by bank directors and officers.

## MISCONCEPTIONS CONCERNING D&O PROTECTION

Some bank executives are operating under the common misconception that the orderly liquidation or supervised administration of the financial institution will create a buffer against personal exposure. In reality, the converse is true: where the organization is in receivership or bankruptcy, stakeholders are more likely to sue the individual executives than the institution (not wanting the bankruptcy process to determine the validity of their claim or its priority). This is also a time when the institution is less able financially to indemnify the individuals against such investigations or claims.

Where the bank is being acquired, directors or officers often feel complacent due to an assumption by the new parent of the obligation to indemnify them. Even where such assumptions are valid, however, the new

parent itself is not prevented from bringing suit against the prior executives. In such instances, the presumption of indemnification in lieu of insurance may be a costly one for the prior management.

## A HARD LOOK

Bank management needs to carefully consider whether their own interests are protected in the event their institution goes the way of so many of their competitors.

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<sup>1</sup>FDIC <http://www.fdic.gov/bank/individual/failed/pls/>

<sup>2</sup><http://www.fdic.gov/bank/historical/bank/>

