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To our Clients and Friends
in the Financial Institutions Industry:

Jim McAlpin wrote an article for the ABA Banking Journal regarding the importance of a Board understanding the scope and quality of coverage provided by the Bank's D&O insurance policy. A version of the information in this letter was published March 24, 2011, on the website of the ABA Banking Journal. We thought you would be interested in Jim's discussion of D&O insurance.

Observations from the Board Room

A friend of mine lost his home to a fire. The fire began at night in the garage and spread quickly. My friend and his family were able to escape without harm, but their home was a total loss. The following day my friend, who is a lawyer, first read his homeowner's policy cover to cover. Before then he could have told you the amount of his insurance premium, and the total amount of coverage, but he was otherwise unfamiliar with the contents of his insurance policy. Fortunately both the policy and the insurance company were above average, and over the next year my friend and his family were able to rebuild their home and replace their lost personal items and furniture. My friend learned several lessons from this experience. His new home has a smoke alarm in almost every room, and he can recite to you the more important provisions of his homeowner's policy.

I have thought of my friend's experience many times over the past several years as I sat in meetings of the boards of directors of troubled banks and their holding companies. As the prospect of a bank failure develops, it is common for members of the board to begin to focus on the scope and quality of their D&O insurance coverage. Such discussions quickly move beyond confirmation of the amount of coverage. The conversation soon develops into an assessment of the relative strength of the insurance company which issued the policy, and the degree to which provisions of the policy may result in roadblocks to accessing payment from the insurance carrier when needed. These are helpful discussions for the board members. The board members develop a better understanding of the degree to which the indemnification provided to them by the bank or holding company will be backed up by meaningful insurance coverage. In a number of such instances, however, the existing D&O coverage is found to be lacking in important respects. Unfortunately, when a financial institution is in troubled condition options are limited for improving existing insurance coverage.

As a result of my experience in working with boards of troubled banks, I have begun to urge the boards of well performing banks to become more actively involved in the procurement process for new or replacement D&O policies. Such purchase decisions are most often left to the management of a bank or holding company, who then rely on an insurance agent or broker to find the most cost effective coverage. There is usually little involvement by members of the board. Any discussion with the board concerning purchase of a D&O policy is typically limited to just the amount of the premium and the total amount of coverage. There seems to be a presumption that D&O insurance coverage is otherwise a commodity. Such a presumption is not accurate, since there can be significant differences in the scope and quality of D&O coverage between policies and among carriers.

The following summary is intended to provide an overview of a typical D&O policy, coupled with tips for enhancing the scope of coverage of a policy, and is not a comprehensive discussion of D&O insurance policies. In my experience as a corporate attorney working with boards of financial institutions and their holding companies, such a framework can be helpful to both board members and senior management.

D&O Insurance Framework

Directors and Officers' liability insurance provides coverage for claims against the insured persons for wrongful acts committed while acting within their capacity as directors and officers of the bank or holding company, or of any subsidiary. It is important to note that coverage under a D&O policy only applies to claims which are made during the policy period, or any extension of the policy period. Actions by the directors and officers which occur within the policy period, but for which claims occur after expiration or cancellation of the policy, are generally not covered.

Since the scope of coverage is for "claims made" for "wrongful acts," the definitions of these two terms are important. It should not be assumed that these definitions are standard, boilerplate provisions which are the same in every D&O policy. Over the past few years, as insurance carriers have become more concerned about the potential exposure of directors and officers of financial institutions, the scope of covered "claims" has been reduced in many new D&O policies.

A typical D&O contract has three main insuring agreements:

Insuring Agreement A covers claims against directors and officers to the extent the bank or holding company is either not permitted or unable to indemnify them;

Insuring Agreement B covers the bank or holding company's obligation to indemnify its directors and officers; and

Insuring Agreement C covers the legal liability of the bank or holding company, and is typically limited to securities claims.

One aggregate limit of liability is shared between all of these insuring agreements, and among all directors and officers. In other words, a $10 million D&O policy would provide an aggregate of $10 million of coverage with respect to all insured liability. In that context, "priority of payment" provisions (discussed below) can be important enhancements to a policy from the perspective of a board of directors.

It is important to bear in mind that the limit of liability under a D&O policy includes legal fees and other defense costs as well as any amounts paid for settlements and judgments. If significant amounts are expended in the defense of a claim, there may be little left in reserve to cover the cost of any adverse judgment or settlement. This factor should be taken into account when determining the appropriate amount of D&O insurance to purchase.

Each of the major D&O insurance carriers offers a different form of policy contract. D&O insurance policies are not commodities and should be carefully read. To add to the complexity of reading and understanding D&O policies, it is often the provisions regarding exclusions from coverage that are the key – but these provisions can be difficult to find and interpret. Each policy will have multiple exclusions described in the body of the policy and, in addition, numerous pages of endorsements attached to the end of the policy document. In observing the approach taken by experienced insurance attorneys and advisors when reviewing a D&O policy, I notice that they almost always start by reading the endorsements at the end of the policy.

Exclusions from coverage in a D&O policy typically include matters which are uninsurable under law or public policy, such as fraud, dishonesty or criminal acts, and matters which would be insured in other policies such as employee benefit plan liability, bodily injury and property damage. Exclusions from coverage will also include any potential claims which have been reported by the bank or holding company to previous insurers. Over the past few years new or renewal D&O policies for many financial institutions have included exclusions for claims made by regulatory agencies. Some D&O policies have also included exclusions for claims related to insolvency. Regulatory and insolvency exclusions are especially problematic, because in the circumstance of a failed bank or an insolvent holding company, the entity cannot indemnify directors and officers and D&O insurance would be looked to in order to fill the gap.

D&O policies will also exclude coverage for claims made by the bank or the holding company against a director or officer. This is the "insured vs. insured" exclusion. In addition, if a new or replacement policy is being obtained, there may be an exclusion of coverage for actions or omissions which occurred before inception of the new policy or a specified date. This is referred to as a "prior acts" exclusion and it should be avoided if possible. Such a provision interrupts continuity of coverage and creates gaps in coverage.

It is important to bear in mind that the application for a D&O policy is expressly incorporated into the policy. "Application" is usually defined to include the application form itself and the financial statements, public filings and any other materials submitted with the application form or incorporated by reference. Application forms typically contain warranties and representations dealing with knowledge of existing claims and circumstances

that might give rise to claims. These warranties and representations can be the basis for the insurance carrier later rescinding the policy or denying coverage.

If you take away nothing else from reading this article, I hope you will better understand that D&O insurance policies can be negotiable contracts. Especially for healthy banks and holding companies, there are many options available when it comes to choice of an insurance carrier. It is also prudent to keep in mind that an "agent" or "agency" is a representative of one or more insurance companies. If you are interested in a comparison of competing insurance product offerings it may be better to engage the services of an insurance broker, who will represent the bank or holding company.

Regardless of whether an agent or a broker is being utilized for the purchase or renewal of a D&O policy, the individuals who will most benefit from the purchase of a strong policy should be involved. The directors of a bank or holding company should, either as a group or through a committee, oversee the process.

Ten D&O Insurance Coverage Enhancements

There are a number of possible enhancements to the standard form D&O policies that can be pursued. The following is a list of some of the more important potential enhancements:

- *Limit the definition of "Application" in the policy to filings for the past 12 months.* The application for a D&O policy is made part of the policy, and a standard representation which is given in connection with the application is that there exists "no knowledge of an existing claim or a matter which may give rise to a claim." Incorporated as part of the "Application," whether by copy or by reference, are the public filings of the bank or holding company. If possible, the filings made part of the Application should be limited to only the prior 12-month period.

- *Expand the definition of "claim."* As discussed above, a D&O policy covers claims made against insured persons within the policy period for covered wrongful acts. I have seen a number of policies in which the definition of "claim" is narrowly drawn, to the extent of only including actual litigation. Effort should be made to broaden the definition of claim as much as possible, to include informal investigations, subpoenas, and other pre-litigation matters.

- *Include severability of Application "knowledge."* Such a provision would provide that no knowledge of "an existing claim or a matter which may give rise to a claim" possessed by an insured person will be imputed to any other insured person. A severability of "knowledge" provision limits the risk of denial of coverage for the innocent directors and officers.

- *Non-rescindable Side A Coverage.* As discussed above, "Side A" coverage applies to directors and officers to the extent the bank or holding company is unable to indemnify them. An enhancement of importance to the directors and officers is to

have such Side A coverage be non-rescindable in the event it is determined that there have been misrepresentations in the policy application or any related materials.

- *Order (or priority) of payments provision.* The coverage amount under a D&O policy is in the aggregate, and is shared between all of the insuring agreements (Sides A, B and C, as described previously) and among all directors and officers. An order of payments provision will afford the individual insureds priority in payments over the coverage provided to the bank or holding company. This can be especially important in a bankruptcy context.

- *Insured vs. insured carve backs for derivative suits and bankruptcy.* D&O policies contain exclusions from coverage for claims by the bank or holding company against a director or officer. "Carve backs" of this exclusion to provide for coverage in the context of derivative suits or bankruptcy proceedings can be important coverage enhancements. For example, in a bankruptcy context the insurance company could otherwise assert an absence of coverage for claims against directors and officers by a bankruptcy trustee.

- *Carve back from regulatory exclusion for defense costs.* Many financial institutions are being faced with exclusions of coverage for regulatory claims. It may be possible to negotiate a carve back from such exclusion in order to cover defense costs only.

- *Limit the insurance company's rights to cancel the policy to only non-payment of premiums.*

- *Limit application of conduct-based exclusions to "final adjudication" standard.* D&O policies contain coverage exclusions for claims relating to fraud, dishonesty or criminal acts. From the perspective of the insured persons, a "final adjudication" standard for application of this exclusion will allow for the advancement or reimbursement of defense costs prior to such final adjudication.

- *Include coverage for punitive damages.*

An additional item for consideration is how best to allocate responsibility for retaining counsel and choosing strategy in any litigation which is covered by the D&O policy. "Duty to defend" polices provide that the insurance company will undertake the defense of the insured persons. These policies are typically less expensive, but they can limit the ability of the insured persons to have an influence on the direction and outcome of litigation. An alternative is to provide in the policy that the duty to defend is allocated to the insureds. The insured persons will then have a greater ability to select counsel and choose strategy in litigation.

Parting Thoughts

The crisis in the banking industry over the past several years has resulted in many lessons learned. One of the least publicized of these lessons is the importance of examining D&O insurance coverage to make sure it will provide the expected amount and quality of

coverage when needed. Depending upon the strength and condition of the bank or holding company, and the interest of the insurance company in placing or retaining coverage, enhancements to standard D&O insurance coverage can be obtained. These enhancements can make a significant difference in the quality of the coverage.

D&O liability insurance provides a source of funding for the indemnification obligations of a bank or holding company to its directors and officers. As a result, it is worthwhile for directors, in particular, to become familiar with the general structure of such policies, and to know what to look for when presented with a policy purchase decision. Time spent in ensuring adequate coverage will pay dividends if that coverage is ever needed.

We hope this overview has been helpful and would be happy to discuss your bank's D&O insurance coverage further with your executive officers or Board. Please fee free to contact any member of the Bryan Cave Financial Institutions Group.

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