D&O Coverage: What You Need to Know Now
by Melissa Neis, QR Insurance

Since the start of 2008, the more than 250 bank failures have cost the FDIC’s Deposit Insurance Fund over $75 billion. With one in 10 banks now on the “problem bank” list, many predict the failed bank figure could double over the next few years. This rising tide of deposit insurance payouts has the FDIC now operating at a deficit and looking to hold directors and officers accountable in order to recover billions of dollars in losses to the Deposit Insurance Fund.

Prediction: Litigation ahead
During the savings and loan crisis (S&L crisis) of the 80s and 90s, the FDIC successfully filed professional liability lawsuits against banking professionals representing a quarter of failed banks, netting a recovery of about $2.5 billion. If we use the S&L Crisis as a guide for what to expect during the current round of bank failures, an onslaught of director litigation is just around the corner. In fact, the FDIC’s former head of litigation has been quoted as saying that litigation is to be expected in about half of today’s bank failures. Though we haven’t seen significant action against directors and officers yet, the FDIC continues to send lengthy civil demand letters warning directors, officers and their insurers of possible charges and the amount of potential damages. This is usually the first step in the FDIC’s investigation into whether or not litigation will be meritorious and cost effective. Historically, this process lasts two to three years and a formal complaint might not be made until just before the statutes of limitation run out.

The IndyMac investigation: More to come?
The FDIC investigation process was illustrated most recently in the lawsuit filed against IndyMac. On July 2, 2010, almost exactly two years after closing, the FDIC filed a 309-page complaint against four former officers of IndyMac’s Homebuilder Division. The painstakingly thorough complaint alleges negligence and breach of fiduciary duty relating to lending practices. Some speculate there may be more lawsuits coming from the FDIC against other former directors and officers of IndyMac outside of the Homebuilder Division. This is not surprising since its failure alone generated the largest deposit insurance payout to date at $17 billion. The sheer size and detail of the IndyMac lawsuit may be the reasons why more complaints have yet to be filed against directors and officers. Subsequent to filing that first lawsuit against IndyMac, the FDIC filed one complaint against the significantly smaller Heritage Community Bank. The agency has also authorized lawsuits against 50 more yet-to-be-named individuals.

What is the impact on your bank and its coverage?
Of the total number of banks that failed in the past two years, 79 percent were community banks with assets of less than $1 billion. Many were located in small towns where the
directors and officers had probably never been sued. If the FDIC were to decide to pursue
litigation against those directors and officers to recover Deposit Insurance Fund losses,
the damage to their personal finances and professional reputations could be devastating.
In situations like this, a comprehensive D&O insurance policy might be the indispensable
protection standing between the FDIC and the personal assets of the directors and officers.

This scenario is even more concerning when you consider the ongoing changes in the
D&O insurance marketplace. For several years before the current round of bank failures,
most financial institutions enjoyed the benefits of a soft market: broad coverage terms,
multi-year policies and significantly lower pricing. For many banks today, the soft market
is largely over and has been replaced by lowered limits, higher deductibles and provisions
that could potentially eliminate coverage.

Beware of the regulatory exclusion
One such provision, informally known as the “regulatory exclusion,” precludes coverage
for suits brought about by a governmental agency. The regulatory exclusion originated
during the S&L Crisis as a direct result of attempts by the FDIC to recover funds from
failed banks, or more specifically from the D&O insurance policies of failed banks. Insurers
specializing in financial institutions could no longer bear the burden of regulatory litigation
against directors and officers. By 1995, an estimated 75% of D&O policies issued
contained this exclusion.

As the economy strengthened towards the end of the decade, most insurers dropped the
regulatory exclusion in favor of broad coverage terms and policy enhancements. Today the
regulatory exclusion is seeing a fast resurgence in policies available to banks with less than
stellar financial metrics. In these situations, it is imperative that directors and officers remain
aware of all provisions included and excluded from their policy, as well as any changes
that might be made to their policy at renewal. The addition of a regulatory exclusion by the
insurer would leave their personal assets exposed in the event of regulatory litigation.

In summary
In times like these, financial institutions need experts to guide them through changes
and uncertainty in the marketplace. While broad insurance coverage might not be widely
available today, insurers who specialize in this area can help your risk management team
strategize your coverage and identify your exposure. Our experts are standing by to help
you better protect your leadership team. Please give us a call at 877.489.4990.

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