Who's to Blame for Inadequate Bank D&O Insurance?

January 9, 2013
By: John F. McCarrick
The D & O Diary

It's a point of increasing discussion – and heated debate – in FDIC claims against the directors and officers of failed banks: the available D&O insurance limits of liability are insufficient to meet the FDIC's settlement expectations, who bears responsibility for purchasing *adequate* bank D&O insurance limits? And who should be blamed if the available D&O insurance coverage proves to be insufficient? To make matters worse, quantifying adequate D&O insurance is akin to aiming at a moving target. D&O insurance is a wasting asset; amounts spent on defense costs and on resolving non-FDIC claims reduce – on a dollar-for-dollar basis – the limits of liability left to settle an FDIC claim made during that same policy period. Should defendant directors and officers of a failed bank be expected to contribute to settlements out of their own, now-thinner wallets. Is this a fair outcome? On a more practical level, isn't there a better way to avoid this outcome?

The Scorecard to Date

Since January 1, 2007, 467 U.S. financial institutions have failed. Of this total, the FDIC thus far has sued the directors and officers of 40 failed banks, and has reported agency authorization to file an additional 49 lawsuits. According to Cornerstone Research, the failures of the 40 institutions that are the subject of FDIC-initiated D&O lawsuits had a median estimated cost to the FDIC of $134 million. Only six of these lawsuits had settled as of December 2012.

One FDIC case has gone to trial. On December 7, 2012 a jury in federal court in Los Angeles awarded $169 million to the FDIC in its suit against three former officers of IndyMac. Given the absence of significant personal assets of the three former IndyMac officers to satisfy this judgment, the FDIC is seeking to intervene in pending coverage litigation in an effort to recover some or all of the remaining D&O limits from IndyMac's 2007 and 2008 D&O insurance towers. However, even a complete win by the FDIC in the D&O coverage litigation would allow the FDIC to recover just a percentage of the awarded jury verdict.

The FDIC's track record in settlement recoveries is not significantly better. The chart below shows reported settlement amounts compared to FDIC estimated losses.

Name of Institution	FDIC Est'd Cost of Failure	Claimed Damages in Complaint	Settlement Amount
	(Millions)	*(Millions)*	*(Millions)*
Westsound Bank	$108	$15	$2
County Bank	$135	$42	TBD

Heritage Community Bank	$42	$20	Not Reported
Washington Mutual Bank	$0	TBD at Trial	$64[1]
First National Bank of Nevada	$862	$193	$40
Corn Belt Bank & Trust Co.	$100	$10	Not Reported

Source: Cornerstone Research, *Characteristics of FDIC Lawsuits Against Directors and Officers of Failed Financial Institutions* (December 2012)

Shortly after the above Cornerstone Research report was issued, former IndyMac CEO Michael Perry reportedly reached an agreement with the FDIC to settle the FDIC's lawsuit against him for a payment by Perry of $1 million out of his own assets plus an additional $11 million in potential insurance funds through an assignment of Perry's rights under his D&O policies.

With respect to the FDIC D&O cases still pending, the insured deposit losses paid by the FDIC in each case generally far outstrip the available D&O insurance proceeds. Moreover, because each failed bank's D&O policies must respond to not only FDIC claims, but also other potential sources of D&O claims, including for example, shareholder and derivative claims, debtor claims brought by or on behalf of the bank holding company and claims brought by creditors of the failed bank, the FDIC is often faced with a materially-depleted insurance asset when it comes time to settle FDIC litigation against the directors and offices of a failed bank. To make matters worse (for the FDIC), the available limits of liability under D&O policies are eroded on a dollar-for-dollar basis by defense costs incurred prior to any settlement across all of these categories of claims and in defending collateral regulatory investigations.

A Solution That is Not Novel

If the perceived inadequacy of D&O insurance limits is an issue of real concern for the FDIC, there is a simple solution to this problem: use the FDIC's regulatory authority to require the purchase of D&O insurance limits in an amount proportional to the amount of risk created for the FDIC by aggregate insured deposits. This approach is by no means novel or creative: in fact, the FDIC already mandates that banks purchase fidelity bond insurance coverage.

By statute, the Federal Deposit Insurance Company can require insured financial institutions to maintain fidelity bonds to insure against such losses, and the FDIC has chosen to mandate that requirement. Other federal banking regulators, as well as most state regulators, also require universal fidelity coverage. For instance, the Comptroller of the Currency requires national banks to have "adequate fidelity coverage."

Similar mandatory purchases of fidelity bond coverage are detailed in the Employee Retirement Security Act of 1974, as amended (ERISA). ERISA Section 412(a) requires that every fiduciary of an employee benefit plan and every person who handles funds or other property of the plan must be bonded, with limited exceptions.

The amount of the ERISA fidelity bond is fixed at the beginning of each plan year and cannot be less than 10 percent of the amount of the funds handled. The amount of funds handled is determined by the amount of funds handled by the person, group, or class to be covered by the bond and by their predecessor(s), if any, during the previous reporting year.[2]

The FDIC also presumably has the authority to specify the *kinds* of D&O products most directly accessible for primarily FDIC recovery purposes. The following chart shows some of the obstacles faced by the FDIC, and the D&O insurance market solutions that have developed in response to similar concerns raised by other kinds of D&O insureds.

Types of Available D&O Insurance

FDIC Perceived Concern	Available D&O market solution	Comments
Inadequate insurance limits	Ample D&O limits capacity through U.S., Bermuda and Lloyd's markets	Limits could be tied to FDIC exposure for insured deposits, as a correlated percentage of those deposits
Dilution of available limits	Side-A D&O insurance	Side A limits are preserved for claims against D&Os when advancement or indemnification from the bank is unavailable due to its insolvency, and provides no coverage for the bank's own liability
Preserved limits for potential FDIC claims	Side-A insurance potentially sitting excess of a traditional ABC D&O tower	Underlying limits would be used for defending and resolving competing D&O claims, including by shareholders and creditors, preserving limits for a more limited set of liability exposures above the standard D&O limits
Denial of coverage by underlying D&O insurers	Side A DIC insurance	DIC (Difference-in-conditions) contains, as one coverage trigger, a denial of coverage by an underlying D&O insurer

So why are these D&O market solutions available now, and why weren't they available in the late 1980s during the last significant wave of bank failures?

The Changed Landscape for Bank D&O Liability -- and for D&O Insurance

The battleground over available D&O insurance for regulatory claims over failed banks bears little resemblance to that of the so-called S&L crisis of the late 1980s. Although D&O insurance had been available for 30-odd years before the wave of FDIC/RTC litigation against failed banks and S&Ls, D&O insurance was still, in the late 1980s, a relatively immature insurance product -- one that had been designed primarily for public companies and their directors and officers facing shareholder class actions and derivative litigation exposures.

The S&L crisis and accompanying D&O litigation brought by banking regulators arguably comprised the first systemic loss event for the financial institutions sector of the D&O insurance industry, and the industry's arsenal of defensive weaponry -- in the form of "insured v. insured" exclusions, regulatory exclusions, aggregation of losses and multiple deductibles -- were tested, to varying outcomes, in state and federal courts throughout the United States. The experience was both difficult and instructive for D&O insurers and bank policyholders. As a result of that experience, D&O underwriters became more aware of the size and scope of potential claims involving bank insureds, and began underwriting to a fuller set of potential exposures. Buyers of D&O bank policies obtained more certainty about how the policies would respond in the event of a bank failure.

In the intervening years since the S&L crisis, there have been two major developments impacting bank D&O insurance. The first is that a series of lengthy competitive (or "soft") underwriting market cycles (punctuated by short "hard" markets) has led to a material broadening of D&O policy terms across all underwriting segments, such that the typical D&O policy of today is materially broader in scope than the typical D&O policy of 1987. Expanded insuring agreements, key definitions and liberalizing endorsements, coupled with narrower exclusions and exclusion triggers, have collectively resulted in a materially broader D&O insurance contract, covering a wide range of entity and individual insureds.

A related development has been an increase in the number of insurers willing to sell D&O policies. This increase in competition, coupled with broader D&O policy terms, has meant that D&O buyers could purchase materially broader coverage from a larger number of insurers, at lower prices. D&O insurers also now offer a number of other related D&O insurance products, such as Side-A only coverage, independent director liability coverage, and investigations coverage to D&O insurance buyers.

The foregoing is an overly-abbreviated list of significant changes relating to D&O insurance that have had the intended effect of making D&O insurance available to buyers on materially better (and broader) terms, and at lower prices. Banks have benefitted from these insurance market developments, and D&O insurance is a routine – albeit voluntary -- purchase for large and small banks in the United States.

The second significant development relating to bank D&O liability insurance since the late 1980s is that banks have materially changed the way they operate and make money. There are numerous reasons why banks have changed their business models since the late 1980s but here are a few of the most significant reasons:

1. The repeal of Sections 20 and 32 the Glass-Steagall Act in 1999 allowed larger banks to engage in commercial activity outside traditional bank deposit and lending activities, including investment banking, securities underwriting and insurance, and even smaller banks were forced to adapt their business models;

2. The rise of mortgage securitizations encouraged banks to sell off their mortgage portfolios, and focus on earning money primarily through loan initiation fees; and

3. Proprietary trading allowed banks to make money by trading for their own accounts.

Of course, not all banks engaged in all of these activities; however, market competition among banks is being increasingly driven by their success in business activities outside traditional bank deposit and lending activities. In the wake of the credit crisis, it is clear that these non-banking activities have the ability to generate – and indeed, have generated -- significant D&O and professional liability claims activity from shareholders, customers, creditors and non-banking regulators, posing significant competition for the very D&O insurance limits the FDIC targets as its primary source of recovery in failed bank D&O litigation.

These two significant developments -- broader D&O polices sold for lower premiums and a potentially broad range of business activities carried out under a bank banner -- set the stage for a drastically different test for the next wave of bank failures.

That next wave of bank failures arrived beginning in 2008 courtesy of the so-called subprime crisis. Falling house prices undermined the packaged securities holding residential mortgages, leading to a near collapse in credit availability, choking off cash flow for banks and their customers.

Of the banks most significantly impaired by the credit crisis, some banks were acquired by larger, more stable banks – with some unfortunate results. Other banks simply failed, requiring the FDIC to compensate depositors for their insured deposits, and place the failed banks into an unduly liquidation process. Litigation inevitably followed -- not just by the FDIC, but also by shareholders of bank holding companies, bank employees whose 401(K) retirement savings were held in the bank's now worthless stock, and bank creditors too.

The FDIC does not appear to have kept up with the collateral liability and D&O insurance developments impacting the financial institutions whose customer deposits the FDIC insures. But, as discussed above, there appear to be some relatively simple fixes available.

For example, the FDIC could require that a bank purchase a minimum level of insurance limits of Side-A D&O coverage, under the reasoning that the FDIC would not want its regulated limits of liability impaired by defense costs, settlements or judgments payable to other claimants by, for example, the insured entity or non-officer employees. Such a required purchase would not prohibit a bank or bank holding company from purchasing broader types of D&O policies including, for example, conventional D&O policies that insure the named entity for securities related claims and other non-FDIC claims.

It is not the ordinary preference of bank managers (or the bank's shareholders) to allocate substantial additional monies each year to D&O insurance premiums. Moreover, bank D&O insurance rates increase across the board when – as was the case in 2007-2010 -- the entire industry sector is financially weakened. Nevertheless, it seems apparent that a scenario in which defendant directors and officers of failed banks must make personal settlement contributions to facilitate the settlement of an FDIC claim in light of impaired or otherwise inadequate D&O insurance limits proves the point that current models used in estimating and purchasing appropriate bank D&O limits are flawed, and negatively impact the FDIC's ability to obtain a reasonable recovery for taxpayers -- while placing bank managers' personal assets at great risk.

This type of solution probably would not have been feasible in the late 1980s, when fewer than 10 insurers regularly underwrote D&O insurance. Today, there are more than 60 insurers selling D&O insurance for U.S. risks, enhancing the ability of banks to secure necessary additional limits of liability from numerous well-capitalized D&O insurers. Of this number, 26 carriers also actively underwrite Side A D&O insurance, suggesting that there are numerous purchasing choices for D&O insurance in general, and Side A insurance, in particular.

Conclusion

Neither policyholders nor D&O insurers favor unnecessarily outsized settlements of bank D&O claims, and there is always a legitimate concern that policyholders could be waste money unnecessarily on overly large or complex

D&O insurance programs. On the other hand, absent some compelling reasons -- such as fraud, self-dealing and the like – it is a questionable rationale for the FDIC to demand personal settlement contributions from directors and officers of failed banks based primarily on allegations of simple negligence and for failing to procure sufficient D&O insurance to meet the FDIC's resolution expectations. If indeed a key driver of demands for personal contributions by the FDIC is inadequate amounts of D&O insurance, there is an easy fix to that problem.

---

[1] Composed of $39.575 million cash obtained from the D&O insurance policies, cash payments from the defendants of $425,000, and their agreement to pay the FDIC an additional cash amount based upon the amounts defendants actually receive, after tax, from certain of their claims pending in the WMI Chapter 11 proceedings (with a $24.7 million pre-tax face value).

[2] If there is no previous reporting year, then the amount is estimated under ERISA Reg. Sec. 2580.412-6.

This publication originally appeared in D & O Diary.