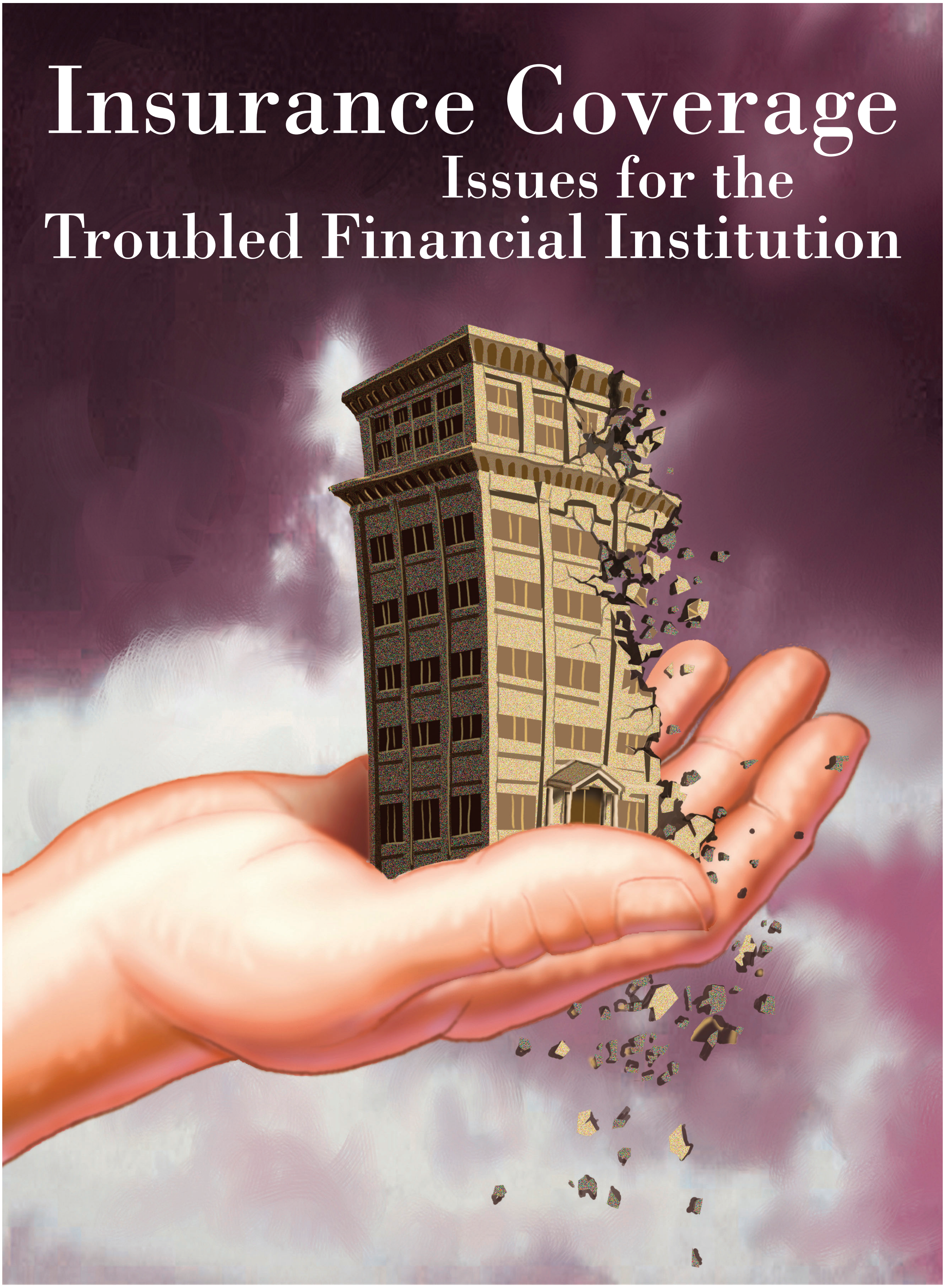
Insurance Coverage Issues for the Troubled Financial Institution



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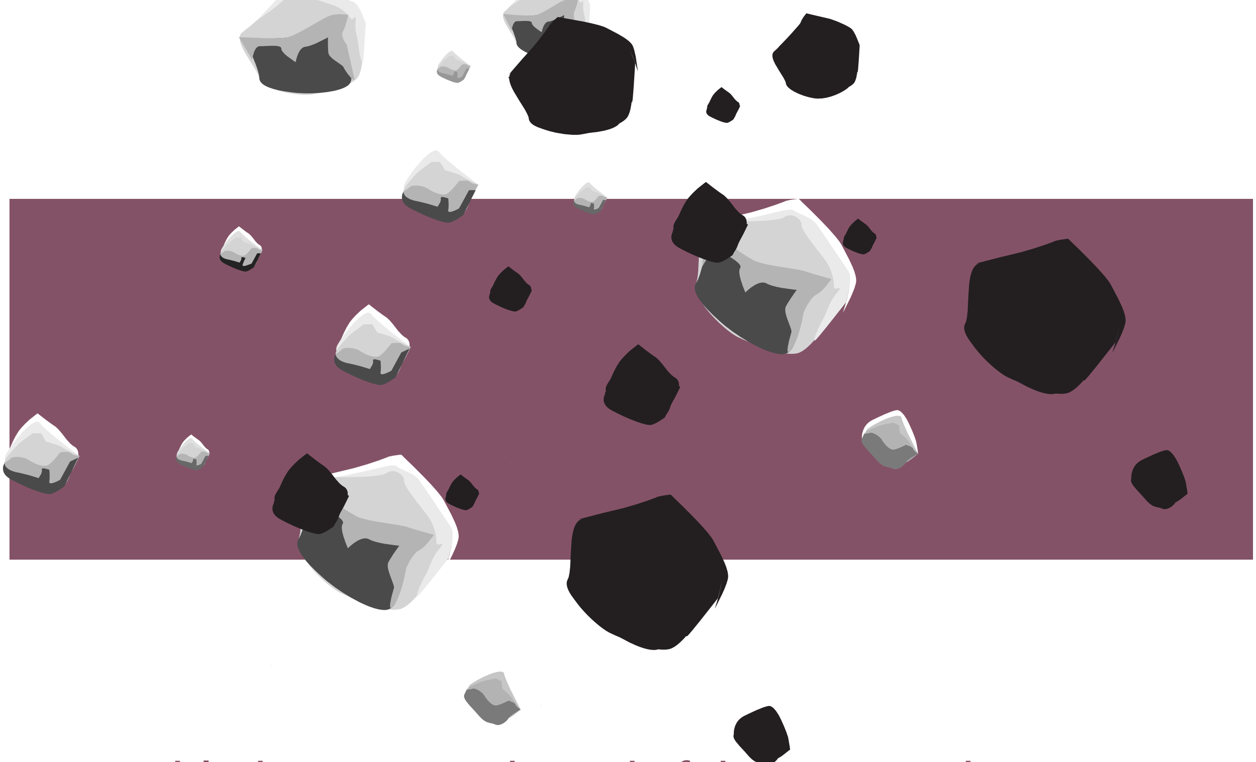

••A troubled institution's board of directors and senior management should consider two types of insurance and plan ahead to preserve any available coverage in the event their institution fails.

BY JOHN C. EICHMAN

IN 2010, FINANCIAL institution failures in the United States reached levels not seen since the late 1980s and early 1990s. The FDIC is scrutinizing the conduct of failed institutions' directors and officers and has begun asserting claims against some of them for breaches of duties owed to the institutions. Shareholders of failed institutions also have asserted claims against directors and officers for alleged breaches of duties or misrepresentations.

The prospect of such claims makes two types of insurance—the financial institution bond and the directors and officers liability policy—as critically important today as they were two decades ago. A troubled institution's board of directors and senior management should give careful consideration to those two types of insurance and ask themselves what steps should be taken to preserve any available coverage in the event their institution fails.

The Financial Institution Bond

The typical financial institution bond provides coverage to the institution for losses it suffers as a direct result of various types of conduct. Dishonest conduct by an institution's directors, officers, or employees is probably the most common basis for claims under the bond. Although policy terms can vary, many dishonesty provisions require institutions to show that the bad actors had the intent to cause a loss and to benefit a third party or themselves. Loss resulting from bad judgment or stupidity is not covered.

Coverage under the bond is triggered by discovery of a loss, which has been construed to mean covered conduct plus the possibility of financial loss. Deadlines for submitting notice of loss and proof of loss, which are conditions to coverage, are keyed to discovery of the loss. Most importantly for the troubled financial institution, the bond terminates automatically upon the "taking over" of the institution by a receiver or by federal or state officials. As a result, when federal or state authorities close an institution, the bond terminates. There is no coverage if discovery occurs after the bond terminates.

Most importantly for the troubled financial institution, the bond terminates automatically upon the "taking over" of the institution by a receiver or by federal or state officials.

What does this mean for the troubled financial institution? Senior management and the directors should be

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vigilant for any type of loss transaction that, if properly investigated, could result in an effective bond claim. If the institution has been victimized by misdeeds that are potentially covered by its bond, it should carefully assess whether to notify its bond carrier. A bond claim can become an important asset of the institution. Although notice can be given after the institution fails, discovery must occur before the institution fails. If the institution did not immediately submit notice to the carrier, it may later be difficult to prove in court that the basis for the claim was discovered before the bond terminated.

After the institution's failure, the FDIC will typically pursue any meritorious bond claim if the institution made appropriate pre-failure discovery. As of late 2010, the FDIC had authorized suits on four bond claims related to recently failed institutions. Recognizing and preserving a bond claim prior to the appointment of a receiver will not only promote the interests of the institution, but might also serve to reduce or minimize the potential liability of its directors and officers.

Directors and Officers Liability Insurance

As of late 2010, the FDIC had authorized suits against 109 individuals for directors and officers (D&O) liability in connection with recently failed institutions.[1] Those institutions' D&O liability policies can be an important source of potential recovery for the FDIC and an important source of potential protection for the directors and officers.

However, the troubled institution, and its directors and officers, should examine the institution's D&O policy to determine what type of post-failure coverage, if any, will be available. Further, if the institution's D&O policy is up for renewal and the carrier is offering to "renew" only with significantly reduced coverage, the institution should consider the options it has to avoid, at least in part, the effects of the reduced coverage—including buying an extended reporting period under the expiring policy. Below are some of the pertinent considerations.

- **The "claims-made" feature.** D&O policies are claims-made policies. In general, coverage is triggered when a third party asserts a claim and notice is given during the policy period. Coverage also is triggered under such a policy if, during the policy period, the institution becomes aware of circumstances which could give rise to a claim and then notifies the carrier of such circumstances. If notice of either the circumstances or the actual claim is not given during the policy period, coverage might be lost.

  Most D&O policies now define "claim," but the definitions vary and need to be carefully considered before notice is submitted. "Circumstances which could give rise to a claim" is not a defined concept. Assessing whether circumstances exist that could be a basis for notice can be challenging in the troubled-bank context. Carriers, insureds, and the FDIC have frequently litigated over whether pre-failure notices were based on adequate circumstances to trigger coverage for post-failure claims by the FDIC. In an effort to reduce the likelihood of such notices, most D&O policies now require the insureds to be quite specific in their notice letter to the carrier by describing the circumstances, the nature of the alleged wrongful act, the nature of the potential damages, the names of the potential claimants and the insureds involved, and the manner in which the insureds first became aware of the circumstances.

- **Application considerations.** Before submitting notice of circumstances which could give rise to a claim, insureds should consider the disclosures made in the institution's last application for the D&O policy. If the insureds submit notice to the carrier but cannot point to a post-application development as giving rise to a possible claim—or, alternatively, could have pointed to a development, but for some reason did not—the carrier might question whether the institution made any misrepresentation in the application for the policy. Misrepresentations in the application can result in the cancellation of coverage not only for the insured who signed the application, but potentially also for any insured who knew the facts that were not truthfully disclosed in the application. The institution's application, therefore, is not a form document to be hurriedly prepared.

- **Possible termination of coverage upon failure.** The insureds' decision whether to give notice of circumstances out of which a claim might arise is particularly important when their D&O policy contains a provision attempting to terminate coverage if a receiver is appointed for the institution. At least one court has recently given such a provision very careful scrutiny and rejected the carrier's effort to rely on it to deny coverage. In *Columbian Financial Corp. v. BancInsure, Inc.,*[2] the court ruled that a provision stating that "coverage shall cease" upon the appointment of a receiver did not terminate the policy, and notice could be submitted and coverage triggered after the failure of the institution. Nevertheless, if a provision of this type were construed as terminating the policy, it could deprive the directors and officers of any coverage unless proper notice had been given 1) during the policy period or any extended discovery period *and* 2) before the institution failed. That possibility will require the insureds to assess, before the failure of the institution, whether they have knowledge of circumstances which could give rise to a claim in the future.

- **The extended reporting period.** Some policies provide for a short (typically, a 30- or 60-day) automatic extended reporting period in the event there is a nonrenewal or termination of the policy. In addition, nearly all policies provide that, in the event of a nonrenewal or termination of the policy, the insureds have the right to purchase an extended reporting period of at least 12 months. Under some policies, or by virtue of some states' laws, the insureds can purchase the extended reporting period no matter who refuses to renew.

If a carrier offers to "renew" the policy with materially reduced coverage or with a materially increased premium, insureds with the right to decline the "renewal" and purchase the extended reporting period should seriously consider buying the extension. Insureds who do not have the right to refuse to renew and then purchase the extended reporting period should consider whether the carrier's offer to "renew" with significantly reduced coverage (for example, the addition of a regulatory claim exclusion) in fact constitutes a refusal to renew and triggers the insureds' right to purchase the extended reporting period.

Insureds should be aware that the coverage provided by the extended reporting period will differ materially among policies. Nearly all D&O policies will provide coverage for third-party claims actually asserted (for example, a lawsuit filed) during the extended reporting period, but only for wrongful acts committed before the end of the policy period. Some extended reporting periods provide only that coverage. Under those policies, notice of the third-party claim must be given during the extended period to trigger coverage. In other policies, the extended reporting period is more generous. Those policies will also provide coverage when, during the extended reporting period, the insureds become aware of circumstances out of which a claim might arise and give notice to the carrier, even if the claim is asserted after the extended period ends.

- **Preserving D&O policy coverage.** What does all of this mean for the troubled institution and its directors and officers?

1. The insureds should examine their policy to assess whether notice of claim, or notice of circumstances that might give rise to a claim, should be submitted. The insureds should consult with counsel about their options. Whether they should submit notice will depend on the particular situation and the particular policy terms, including whether the policy purports to terminate when a receiver is appointed. Before submitting notice of circumstances, insureds should always consider what was disclosed in the last policy application.

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2. If the policy period is ending, the institution should be very careful about the accuracy and completeness of its renewal application. Inaccurate renewal applications are difficult to explain in post-failure coverage fights.
3. If the carrier refuses to renew the institution's D&O policy, the institution should almost always purchase the extended reporting period. If the carrier has offered to "renew" the policy on significantly more limited terms, the insureds should consider whether they can nonrenew the policy themselves or treat the offer as a nonrenewal by the carrier and purchase the extended reporting period.
4. If the insureds intend to purchase the extended reporting period, they should determine whether they can trigger coverage during the extended period by submitting notice of circumstances or just by providing notice of a claim. If the policy has the latter, less generous coverage, the insureds should consider whether to give notice of circumstances before the policy period ends, in case a "claim" is not actually made until after the extended reporting period ends.

Conclusion

The financial institution bond and the directors and officers liability policy are potentially important assets for the troubled financial institution and its directors and officers. The leadership should take care to determine whether it should act to preserve coverage before the institution's failure. ❖

John Eichman *is a partner at Hunton & Williams LLP and co-head of the firm's Complex Commercial Litigation Practice Group. He can be reached at* jeichman@hunton.com *or* (214) 468-3321.

Notes

1. The FDIC publishes updated information at http://www.fdic.gov/bank/individual/failed/pls/index.html.

2. *Columbian Financial Corp. v. BancInsure, Inc.,* No. 08-2642-CM, 2009 WL 4508576 (D. Kan. Nov. 30, 2009).