BYBEL RUTLEDGE LLP

LEGAL ALERT

March 18, 2014

D&O Insurance—What's in Your Wallet?℠

Dear Clients and Friends:

We believe strongly that a good defense begins with a good offense.

In the area of D&O insurance, a good offense begins with knowing the type and amount of coverage you have **before** you need it.

This means putting procedures in place to systematically review and evaluate D&O insurance coverage needs in context of ever changing business conditions and threats.

The FDIC, in its recent Letter #47-2013, similarly urged boards of directors and officers to "take stock" of their current D&O insurance coverage.

Regrettably, over 50% of respondents in a recent Towers Watson survey on D&O insurance indicated that they had not undertaken an independent review of their D&O insurance within the last two years.

Although the D&O insurance market generally has been "soft" for the last several years, it may not continue.

Furthermore, the softness or hardness of an insurance market cannot be measured solely in the amount of premiums charged.

A "hard" insurance market also can mean a significant reduction in the types of risks an insurer is willing to underwrite, even if premiums remain unchanged.

Now may be the time to take advantage of insurance market conditions to expand coverage or increase policy limits.

We urge our community banking clients and friends, as part of their fiduciary obligations to their financial institution, to make 2014 the year in which they conduct a thorough evaluation of their current coverage.

To assist in the education of board members, attached is an **Introduction to D&O Insurance** prepared by our firm and which will be the basis of a presentation on the subject at the upcoming **2014 Directors Institute** to be held on **Wednesday, March 26, 2014** at the Hershey Golf Club, Hershey, PA.

The **Introduction to D&O Insurance** as well as our **Directors Institute** presentation is based upon our review of a number of insurance policies for community bank clients as well as our independent research.

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"What's in Your Wallet?" is a registered service mark of Capitol One Financial.

In this regard, we have developed a data base that compares almost all of the variable components of D&O insurance offered by a number of different insurers that underwrite for community banks.

Hence, we are uniquely positioned to assist boards of directors and executive management in their review of coverage by providing them with the benefit of our experience and access to our data base of comparative information.

We also realize that D&O insurance may be only one component of your overall insurance program. In that regard, we also have experience in reviewing other insurance coverage and showing how it relates to your D&O policy.

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INTRODUCTION TO D&O INSURANCE

On October 10, 2013, the Federal Deposit Insurance Corporation ("FDIC") issued Financial Institutions Letter 47-2013 ("FDIC Letter") applicable to all FDIC insured depository institutions. In the letter, the FDIC advised that it had noted an increase in the exclusions in director and officer insurance policies purchased by financial institutions which may limit coverage in certain circumstances thereby increasing potential personal exposure of board members and bank officers to civil liability. In this regard, the FDIC emphasized the need for boards to review their D&O coverage and make choices of D&O coverage based upon a well-informed analysis of costs and benefits.

Towers Watson D&O Survey

Similar to Capitol One's credit card marketing query "What's in Your Wallet?"sm , the FDIC wants financial institutions to know what is in their D&O insurance portfolio.

Some interesting statistics from a 2012 survey of D&O insurance by Towers Watson:

- Almost 70% of company directors raised an issue about the amount and scope of coverage.
- Over 50% of respondents had not conducted an independent review of their D&O insurance within the last two years.
- 21% of respondents were dissatisfied in how their D&O claim was handled.
- Almost 20% of private company directors were unsure how their D&O insurance was structured.

Although this survey included, but was not limited to, financial institutions, the fact that over one-half of respondents had not conducted an independent review of their D&O insurance tends to validate the point made in the FDIC Letter. Furthermore, with respect to privately held companies, a full one-fifth of directors were unsure as to how their D&O insurance was structured. Also of note is the rather high rate of dissatisfaction among insureds with how their insurers handled claims.

The Towers Watson survey also included data relating to the top claims concerns of directors. The following were the top concerns ranked by importance:

- Regulatory
- Direct shareholder/investor suit
- Derivative shareholder/investor suit
- Employment related
- Fiduciary (including ERISA)

The Towers Watson survey also contained information concerning claims experience in the last ten years. In this regard:

- 36% of respondents reported having a claim within the past 10 years.
- For public companies, the highest categories of claims were derivative shareholder suits, direct shareholder suits and regulatory.
- For private companies, the highest categories of claims were derivative shareholder suits, direct shareholder suits and employment related.

Understanding the Relationship

In approaching D&O insurance, it is vital that the insured understand their relationship with the insurer. Insurers are in the business of collecting premiums and scrutinizing claims. Insurers analyze potential settlement of claims in context of cost/benefit to them, not whether the claimant is "right" or "wrong" in his or her assertion of liability on the part of the financial institution. Since a large portion of initial claims expense will be the "reasonable attorneys' fees and expenses," payment of claims can become a negotiation process between the insured and the insurer over what is reasonable. In this regard, it should be remarked that one-fifth of all respondents to the 2012 Tower Watson survey were dissatisfied with how their claims were handled.

Introduction to the Subject of D&O Insurance

Entire textbooks could be written on the ins and outs of D&O insurance and the legal implications thereof. Indeed, many court cases feature litigation between an insured and the insurer arguing over coverage or the extent of coverage.

In light of the FDIC Letter, the following is intended to provide directors and executive officers with a general introduction to, and overview of, the subject of D&O insurance. As a result, it is not possible to address every type of provision or nuance of D&O coverage. Part I addresses the major insuring agreements contained in most D&O policies. Part II describes major provisions of D&O policies and the important role they play in determining whether an institution is entitled to coverage.

How Bybel Rutledge LLP Can Assist Boards of Directors and Executive Management

Bybel Rutledge LLP has reviewed a number of D&O policies for community bank clients and has developed a data base which compares almost all of the variable components of D&O insurance offered by a number of different insurers underwriting insurance for community banks. As boards of directors and executive management seek to comply with the FDIC Letter by undertaking an examination of their D&O insurance needs and current coverage, we are able to assist boards and officers in this process by providing them with the benefit of our review experience and access to our data base of comparative information.

PART I

It's More than Just D&O

For financial institutions, D&O insurance invariably is bundled into an overarching policy that will include insuring agreements for other coverage, such as fiduciary coverage, employment practices liability coverage, professional services coverage and securities coverage.

Although there will be definitions and coverage exclusions common to all policy provisions, each insuring agreement will have its own additional set of definitions and exclusions specific to that insuring agreement. The presence of endorsements to the policy as a whole or to any specific insuring agreement only adds to the complexity and verbiage attendant to D&O insurance.

The foregoing is compounded by the lack of standardization across the industry. Each insurer will offer a "standard" or "specimen" policy containing its own unique definitions and exclusions. Institutions should not necessarily accept these standard policies at face value and, if there is a risk an institution wishes to be covered, it should negotiate coverage of that risk by means of an endorsement. Insurers generally are willing to modify their standard policy if the risk to be covered is approved by their underwriting department and the institution is willing to pay the assigned premium.

Insurers constantly are reevaluating their underwriting standards and the risks they are willing to cover based on a number of factors, including claims experience, results of litigation, general economic conditions, and premium revenues. As a result, terms available in previous policies may no longer be offered or definitions previously used may have been changed. Some insurers may underwrite policies only for financial institutions of a certain asset size.

Insurers also may specialize in insuring particular risks and may offer products for insuring those risks that are superior to those offered by other insurers. However, due to the multiplicity of risks being addressed, an institution may prefer to deal with one insurer rather than pick *a la carte* policies from different insurers to address different risks (if they are available on an *a la carte* basis which may not always be the case).

To encourage such behavior, insurers usually reward policyholders with lower premiums if they place all their insurance through them. The result sometimes is that, although there otherwise may be better singular policies (or endorsements) available with regard to insuring specific risks, the institution may prefer (or be required) to purchase a comprehensive insurance program offered by a single insurer as it may simplify overall risk management in a cost-effective manner.

D&O Coverage

Basic D&O insurance will provide coverage for officers and directors for alleged wrongful acts, including breach of fiduciary duty, for which they have been indemnified by the financial institution. It also will reimburse the financial institution for the amounts paid to officers and directors as indemnification.

Excess Side-A Non-Indemnifiable Coverage. Often, boards are faced with the decision of whether to obtain what is referred to as Excess Side-A DIC insurance. This coverage is designed to pay for non-indemnifiable losses such as if the issuer of the policy (1) wrongfully refuses to indemnify the individual insureds as required by the underlying policy or in a timely manner; (2) is financially unable to indemnify the individual insureds or (3) actually or purportedly rescinds the policy. Coverage also is afforded where the limits of the underlying policy have been exhausted or, under the terms and conditions of the underlying policy, the insurer is not liable for such non-indemnifiable loss. The latter is an example of a "Difference-in-Condition" policy where there may be coverage under the Excess Side-A insurance but not the underlying policy. Under those circumstances, the Excess Side-A policy will "drop down" to provide coverage.

Excess Side A coverage also would be available where, pursuant to a liquidation, reorganization or rehabilitation or similar proceeding commenced under the U.S. Bankruptcy Code or similar federal or state law and, as a result of such proceeding, the proceeds of the underlying policy cannot legally be paid by the insurer.

Derivative Investigative Demand. Under Section 1782 of the Pennsylvania Business Corporation Law, shareholders may bring an action to enforce a secondary right on the part of one or more shareholders of the corporation against any present or former officer or director of the corporation because the corporation refuses to enforce rights that may properly be asserted by it, provided that the shareholder bringing the action was a shareholder of the corporation or owner of a beneficial interest in its shares at the time of the transaction of which he complains.

To establish the element of "refusal," required by Section 1782, such shareholder initially would make a "demand" upon the board of directors of the corporation to enforce such right on behalf of the shareholders. This commonly is known as a "shareholder derivative demand."

In response to receipt of a shareholder derivative demand, the board of directors generally will constitute a special committee of independent directors to review and analyze the shareholder derivative demand and make recommendations with respect to the corporation's response thereto. In this regard, the special committee may engage independent counsel, auditors and other professionals to assist in the evaluation of the shareholder derivative demand. To cover these additional costs, D&O policies may include a provision which reimburses the corporation for costs incurred in connection with a shareholder derivative demand up to a stated amount (usually $100,000).

Coverage for Service with Non-Profit Organizations. Many financial institutions view active involvement of officers and directors in non-profit organizations in their communities as an important part of their marketing strategy as well as representing a genuine desire to give back to the communities that support them. In this regard, bank officers and directors may serve as officers and directors of non-profit organizations.

Although most insurers will extend D&O coverage of officers and directors of financial institutions to include their role as officers and board members of non-profit organizations, almost all require such service to be with the knowledge and consent of the institution and at its specific request. Coverage, however, will not commence until the non-profit organization's D&O insurance limits are exhausted.

To ensure coverage under the institution's D&O insurance, the institution should maintain written documentation memorializing that each individual's service as an officer or director of a non-profit organization was with the knowledge and consent of the institution and such service was undertaken at the institution's specific request.

Civil Money Penalties. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 authorized the imposition of civil money penalties ("CMP") by federal banking regulators. Since that time, some insurers have offered, and banks have purchased, insurance which covered CMPs up to specified limits. In some instances, the institution, in turn, may have assessed the costs of the CMP coverage to its officers and directors who reimbursed the institution with personal funds.

This situation continued until FDIC examiners issued a citation against two Louisiana banks in the Summer of 2011 stating that their CMP insurance coverage violated 12 CFR 359.1. Although Bankdirector.com has reported that it is unaware of any similar citations being issued by FDIC examiners since 2011, the FDIC took the opportunity in the recent FDIC Letter to reiterate its position on this issue, perhaps in an effort to give banks sufficient time to conform their practices to the FDIC Letter before issuing any further citations.

In the FDIC Letter, the agency emphasized that financial institutions are prohibited from purchasing insurance that would be used to pay or reimburse officers or directors for the cost of any CMP assessed against such person in an administrative proceeding or civil action commenced by any federal banking agency.

The *American Banker* has reported that the Association of Bank Directors wrote to the FDIC's General Counsel ("FDIC Counsel") in 2012 arguing that 12 CFR 359.1 does not prohibit CMP insurance which is not paid by the institution. It was reported that the FDIC Counsel takes the position that, although premiums for CMP insurance coverage may be paid by officers and directors, having such CMP coverage in the institution's (or its holding company's) name is a violation of 12 CFR 359.1.

Even an individual policy that would cover CMPs that is between an officer or director and an insurer paid by such officer or director with personal funds may not pass muster in that FDIC Counsel indicated that the same public policy concerns of encouraging persons to take actions that could put them at risk of CMPs would be the same as if the institution obtained the insurance on their behalf which is prohibited.

To date, it does not appear that the insurance industry has responded by offering an individual insurance product available to officers and directors which they could purchase individually to cover CMPs.

Employment Practices Liability Coverage

Employment practices liability ("EPL") covers wrongful employment acts and employment related bodily injury, such as mental anguish or emotional distress. There are a number of employment related laws that impose liquidated damages, penalties or plaintiff's attorneys' fees and other costs on persons found to have violated those laws. There is little consistency in coverage among insurers in covering these costs. Some cover few of these costs while others cover most costs. Insurers uniformly, however, will not cover costs related to complying with non-monetary or injunctive relief, such as costs of providing reasonable accommodation under the Americans with Disabilities Act.

Employees Covered. With respect to EPL coverage, it is important to define what types of employees are covered, such as full time, part time, temporary, seasonal, leased, loaned or belonging to independent contractors. Some insurers will extend the definition of employee to include volunteers which might be useful if the institution routinely sponsors events that involve large numbers of volunteers.

Coverage for Service with Non-Profit Organizations. Of concern to bank officers and directors serving as officers and directors of a non-profit organization should be whether the institution's EPL will cover them for alleged employment related wrongful acts committed with respect to an employee of the non-profit organization. This is a key point, particularly if the non-profit organization does not have its own EPL policy or only has one with modest limits of insurance. Similar to D&O coverage, any EPL coverage that would extend to service as an officer or board member of a non-profit organization will not commence until after any EPL coverage of the non-profit organization has been exhausted.

Although a number of insurers will exclude such coverage, there are insurers that will extend such coverage under certain conditions. However, they will require that service as an officer or director of the non-profit organization must be with the knowledge and consent of the institution and undertaken at the institution's specific request. Further, the insurer may limit coverage to non-profit organizations that are tax exempt under specific sections of the Internal Revenue Code.

Coverage for Harassment and Discrimination against Third Parties. Certain insurers offer EPL coverage for sexual harassment and discrimination claims made by third parties. This coverage may be of special interest to financial institutions whose business plan involves large numbers of customers, clients, vendors, suppliers, service providers and other business invitees entering the premises of the institution and interacting with its representatives.

Use of Social Media. Insurers have addressed this issue either under EPL coverage or under a separate policy applicable to electronic/internet banking liability ("Internet Policy"). In this regard, the particular concern for institutions is a claim made by a customer or employee against it for slander, libel, invasion of privacy, false light, emotional distress or mental anguish as a result of something which an employee of the institution or a person allegedly controlled by the institution posted to social media. Some insurers limit coverage to social media which the insured institution either monitors or controls and for which it has adopted policies and procedures on use and access.

Workplace Violence and Stalking. Since a bank's plan of business may attract persons who may use or threaten the use of deadly force in connection with an attempted robbery, some insurers offer limited coverage for costs incurred in connection with workplace violence. Some insurers include "stalking" within the definition of workplace violence. Insurers have addressed coverage for workplace violence variously in their EPL coverage, Internet Policy or Financial Institution Bond.

Fiduciary Liability

Fiduciary liability insurance covers losses arising from claims made in connection with the administration of employee benefit plans operated by the insured for its employees or a violation of any of the responsibilities, obligations or duties imposed on the insured by the Employment Retirement Income Security Act ("ERISA"). Administration includes counseling employees with respect to interpreting, handling records in connection with, or effecting enrollment or cancellation of employees under an employee benefit plan.

Fiduciary liability insurance usually covers costs involved (including fines, penalties and sanctions payable to a governmental authority) in participating in a voluntary correction program for the actual or alleged inadvertent non-compliance by an employee plan with any statute, rule or regulation up to a stated amount. Larger financial institutions that may administer multiple plans should ensure that that their insured limits are appropriate in context of the amount of assets subject to their administration.

HIPPA and COBRA Penalties. For institutions that violate certain provisions of the Consolidated Omnibus Budget Reconciliation Act of 1985 or the privacy provisions of the Health Insurance Portability and Accountability Act of 1996, government agencies may impose civil money penalties. Some insurers offer, as part of their fiduciary liability coverage, to indemnify the insured for these civil money penalties up to a stated amount.

Securities Liability

A securities liability insuring agreement insures against losses incurred by the insured for omissions of material fact or misstatements of material fact made in connection with the purchase or sale of, or offer to purchase or sell, securities issued by the insured and, if a holding company of a financial institution is subject to the reporting requirements of the federal securities laws, reports filed with the U.S. Securities & Exchange Commission ("SEC"). Since many civil suits involving securities seek to be qualified as class actions, the policy specifically should include coverage for securities class action lawsuits.

It is important to note, particularly for non-SEC reporting companies, that this coverage can be quite useful even where the issuer is not actively engaged in significant capital raising activities. Share buybacks, employee stock purchase plans, officer and director stock option plans and similar programs involve the offer, sale or purchase of a security for which this coverage may be desirable.

Unless otherwise specified, these insuring agreements will not cover securities brokerage or investment advisory services. Also, insurers generally will exclude from coverage any claims alleging that the price or consideration paid for a security by the insured (usually in context of a merger or acquisition) was inadequate.

Internet/Electronic Banking Liability

Almost all financial institutions offer internet banking, often through third party service providers. A prerequisite for internet banking is establishing and maintaining a web site and larger institutions may use more than one web site to deliver products and services.

Internet banking, however, also raises the potency and probability that a financial institution may be the victim of cyber crime or extortion. Cyber crime may constitute a deliberate attempt to interrupt the institution's business due to malicious attacks on its computer systems or (2) theft or intentional misuse of confidential customer data in the custody or control of the bank or its electronic data processor. Cyber extortion may include threats of DNS attacks or insertion of malware unless the institution agrees to the demands of the perpetrator who likely will be operating from a jurisdiction outside of the United States.

Prior Dishonesty Exclusion. Often Internet Policies will exclude coverage for harm intentionally or deliberately caused by employees, consultants or independent contractors that occurs after an officer or director (not in collusion with such person) learns of any fraudulent, dishonest or criminal act by such perpetrator regardless of whether the harm caused by such act would have been covered by the Internet Policy. This requires institutions to employ rigorous screening procedures with respect to persons it permits access or use of its computer systems and electronic networks.

Privacy Liability Mitigation. Most institutions offering internet banking should have coverage which will reimburse them for costs incurred from the unauthorized access to confidential customer information in the custody or control of the bank or its third party electronic data processor arising from the negligent management, oversight or preservation of such confidential information by the bank or its third party electronic data processor. Such expenses normally include those associated with (1) issuance of new account numbers and credit, debit and ATM cards and (2) obtaining, with the consent of the customer, a credit monitoring service for a specified period of time (usually one year).

Cyber Extortion. Institutions offering internet banking also need to consider their vulnerability to cyber extortion. Cyber extortion can include not only threats to hack computer systems but also the delivery of threats over the internet to do bodily harm to an individual who has been kidnapped by the perpetrator. Usually, the extortionists' demands are for the delivery of money to offshore accounts or the download or release of confidential proprietary or customer information. Although Internet Policies generally will reimburse the institution for loss of property given to an extortionist, they are not uniform in covering expenses relating to reconstructing or rehabilitating compromised computer programs or records. Similarly, policy terms vary as to the reimbursement of expenses in circumstances involving kidnapping, such as medical, psychiatric and rehabilitation expenses, travel and accommodation expenses and expenses of independent negotiators.

Territoriality. Due to the nature of the internet, it is important that the Internet Policy covers threats emanating anywhere in the world.

PART II

Applying for Coverage

Although completing an application for insurance may appear to be a ministerial act, policies invariably provide that coverage may be denied based upon misstatements made by, or with the knowledge of, an insured on a policy application. Although statements made by, or with the knowledge of, one insured usually will not be imputed to other insureds to deny coverage to an individual insured, statements made by, or with the knowledge of, executive officers generally will be imputed to the institution. However, policies vary widely as to whether statements made by, or with the knowledge of, executive officers will be imputed to the institution based upon a "knowing," "intentional," or "negligence" standard.

Increasingly, insurers are incorporating by reference into their applications all information about the insured that is publicly available or has been filed with any regulatory agency within the previous 12 to 24 month period. For financial institutions, this means all filings made with regulatory agencies including, where applicable, the SEC will be incorporated by reference into the insurance application.

Multi-Year Policies

Insurers who write multi-year policies want the ability to review the terms of the policy and increase premiums if certain significant events occur, such as change of ownership (usually 10% or more), sale of assets (usually 50% or more), institution of a regulatory proceeding or material adverse changes in financial condition. In most cases, the insured is under an affirmative duty to notify the insurer upon the occurrence of the enumerated events within a specified time period upon pain of cancellation of the insurance.

With multi-year policies, it also is important to note whether the available limits are for the policy year (ie annually) or for the policy period which is the length of time for which the policy was underwritten.

Who is an Insured under the Policy?

Invariably, the institution will be an insured as will subsidiaries over which it has 50% or more of voting equity securities. Some insurers also will include non-profit organizations sponsored by the institution.

Most policies will include past, present and future directors as insureds. However, if the institution maintains advisory boards or bestows a title of honorary director or director emeritus, care should be taken to determine if such individuals are included as insureds.

Employees, including officers, are deemed to be covered but policies may include or exclude certain categories of employees, such as part-time, temporary, seasonal, leased, loaned or employed by independent contractors. Some will include volunteers which may be important if the institution sponsors events that involve a large number of volunteers.

Persons related to the insured or which legally represent the insured generally are included, such as spouse, domestic partner, heirs, estates, legal representative and assigns but only to the extent that the claim is based upon coverage that would have been available to the insured individual.

What Constitutes a Claim?

This is a critical provision because it determines if defense of a claim is covered by the policy. Most policies will cover claims based upon:

- Written or oral demand for money damages or non-monetary relief;
- Civil proceeding commenced by filing of a complaint;
- Formal administrative or regulatory proceeding commenced by filing of charges, formal investigative order or similar document;
- Criminal proceedings;
- Arbitration, mediation or similar alternative dispute proceeding; and

- Written request to toll or waive a statute of limitations relating to a potential claim.

Since "regulatory" issues topped the list of director concerns in the 2012 Towers Watson D&O Survey, institutions should be concerned whether their D&O insurance covers costs incurred in:

- Complying with requests from regulators to provide information on an informal basis;
- Preparing to meet with or be interviewed by a regulatory authority; or
- Responding to issuance of civil, criminal or regulatory subpoenas, *Wells* notice or U.S. Attorney or Grand Jury target letter.

Claims Notification

Generally, there is a finite amount of time given to an insured to report a claim to the insurer that the insured believes is covered by the policy. Some insurers, usually for an additional premium, will offer an extended reporting period.

The burden of reporting a claim generally falls upon an executive officer who has notice of the potential claim. The term executive officer is defined in the policy and may include internal auditors, controllers, risk managers and senior loan officers. In addition, these reporting responsibilities are imposed on the respective officers of any subsidiary. For larger institutions that operate through a number of subsidiaries whose executive officers may be different from those of the holding company or the bank, it is important that such officers understand their responsibility to report a potential claim of which they become aware in the manner and within the time period specified in the policy.

Who Has the Duty to Defend a Claim?

Some insurers will permit the institution to elect who will defend a claim. If the insurer has a duty to defend, it should defend even where the claim is false or groundless. If the insured has a duty to defend, there should be a provision for the insurer to advance defense costs, subject to indemnity by the insured should it ultimately be determined that coverage was unavailable.

Almost all D&O policies are written with defense costs included within the overall limits of the policy. If the defense costs exceed the policy limits, the insurer's duty defend or advance defense costs terminates immediately, even if in the middle of litigation. Therefore, it is important that the institution be comfortable with the limits of insurance in its policy.

What Losses May Be Covered?

Generally, insurers will pay (1) defense costs (reasonable attorneys' fees and expenses); (2) actual, punitive, exemplary, compensatory and multiple damages; (3) pre-judgment and post-judgment interest and (4) bonds required on appeal. Insurers generally will not pay (1) expenses incurred related to non-monetary damages; (2) fines, civil penalties and taxes and (3) disgorgement and restitution. Defense costs usually will not include salaries, wages, fees, overhead or benefit expenses associated with officers, directors or employees of the insured.

Policies vary widely as to whether an insurer will or will not cover (1) attorneys' fees and court costs assigned against the institution by a settlement or court order; (2) liquidated damages under the Age Discrimination in Employment Act, Equal Pay Act or Family Medical Leave Act; (3) Sarbanes-Oxley 304/Dodd-Frank 954 costs (clawback of executive compensation provisions); (4) non-willful civil penalties under Foreign Corrupt Practices Act; (5) non-contestability of coverage for violations of Section 11, 12 or 15 of Securities Act of 1933, as amended; (6) shareholder derivative demand investigation costs or (7) short swing profits under Section 16(b) of the Securities Exchange Act of 1934, as amended.

Non-Rescission Provision

This is an important provision that should be in every D&O policy. In this provision, the insurer agrees not to rescind or void, in whole or in part, any coverage provided by the policy to any insured. This does not mean that an exclusion from coverage may not apply but the insurer will not be able to void the policy at will, absent misrepresentation in the policy application.

Insured vs. Insured Exclusion

Most policies will have a provision known as the "insured vs. insured" exclusion. Simply stated, an insured cannot instigate a covered claim by another insured. This is designed to deter officers and directors from colluding to have the insurer pay for what may have been a poor business decision or lack of proper internal controls. Therefore, policies will exclude claims otherwise covered that are encouraged, solicited, suggested, facilitated or recommended by an officer or director, except where such claims are (1) whistleblower claims, (2) cross-claims or third party claims for contribution or indemnity under the policy, (3) employment practices claims or (4) claims brought solely in a shareholder capacity.

Insurers are now extending this exclusion to cover a certain period of time after directors retire or leave the board, usually for a 3 or 4 year period measured from the time the claim is made. Insurers also are extending this exclusion beyond officers and directors to include general counsel and chief risk officers.

Illegal Profits/Fraud Exclusion

Another common exclusion is that coverage will not be afforded to an insured for activities which (1) resulted in the insured obtaining illegal profits or gains or (2) constituted a deliberate fraudulent, dishonest or criminal act or willful violation of law. Knowledge of a board chair and executive officers generally will be imputed to the institution.

In determining whether the exclusion applies, policies include varying standards, including (1) a mere allegation, (2) a judgment, (3) a final adjudication or (4) a final, non-appealable adjudication. From the perspective of the insured, the latter standard is the most desirable.

D&O and Other Insurance

D&O insurance should constitute an integral part of an overall risk management program. Therefore it is important to understand how D&O insurance interacts with other insurance the institution may have purchased. Usually, D&O coverage is considered primary unless the claim is covered by another insurance policy in which case it usually is deemed to be secondary. Therefore, if a claim would be covered by D&O insurance and general liability insurance, the general liability insurance would be deemed to be primary and D&O coverage secondary. If an institution would want its D&O coverage to be primary, it should require that the other insurance state specifically that it is excess to the D&O insurance.

There appears to be on ongoing evolution in standards as to other insurance being treated either as (1) whether or not collectible or (2) valid and collectible. The former standard infers that coverage under the policy can be invoked only when the amount of loss (including defense costs) exceeds the applicable retention amount and the limits of liability of the other insurance whether or not such insurance is collectible from that insurer and then only for the amount that is in excess of those limits.

On the other hand, use of the term "valid and collectible" when referring to other insurance appears to be more favorable to the insured in that if other insurance is available but uncollectible (*ie* the insurance company is in liquidation), coverage under the policy should commence after whatever amount, if any, of other insurance is collected from the insurer (minus any retention amount) even if it is less than the limits of such insurance. Therefore, it would appear that, in regard to other insurance, inclusion of the "valid and collectible" standard is preferable from the insured's perspective.

Settlement of Claims

It is important to understand that, under most policies, the insured has no right to settle a claim or admit liability and the insurer has the right to settle any claim whether or not the insured agrees with the settlement recommended by the insurer. With respect to those policies which permit an insured to disagree with a recommended settlement, the insured, upon exercising such prerogative, usually will incur the cost of defense and any damages above and beyond the settlement amount that was agreeable to the insurer and the person making the claim.

Territoriality

Generally, claims covered by a D&O policy include claims arising anywhere in the world. More important is what the policy says about where the claim is brought. Under some policies, an insurer only may have a duty to defend covered claims that are brought in the United

States, Puerto Rico or Canada. Therefore, if a covered claim is brought in a tribunal outside of those jurisdictions, there could be no duty to defend and the insured could be responsible for defense costs and any damages. Although territoriality appears to be an important issue to be addressed in any policy, not all policies contain such a provision.

CONCLUSION AND CHECKLIST

D&O policies vary from each other and the variance can be substantial. Each policy has its own set of definitions, coverages and exclusions. In light of the FDIC Letter, boards should task executive management to undertake a review of existing D&O coverage and present an analysis to the board either directly or through the board's risk management committee. In addition to types of current coverage, the analysis should include a review of the standards and exclusions contained in the policy which can be used by the insurer to deny coverage. Thereafter, the board will be equipped to negotiate the terms and extent of desired coverage on a going forward basis.

To assist management in this task, attached is an initial checklist of important provisions which should be addressed in any D&O policy.

DISCLAIMER

Neither Bybel Rutledge LLP nor any of its members or employees are licensed insurance professionals or hold themselves out as such. The foregoing is a compilation of our legal review of the comparative features of D&O policies issued by a number of different insurers. Insurers continuously are revising policy terms and provisions based on economic and market factors and the results of litigation. Therefore, terms or provisions which we previously have reviewed may no longer be offered.

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INITIAL CHECKLIST FOR D&O INSURANCE

- ☐ Applying for Coverage
  - ☐ Imputation of knowledge
  - ☐ "Knowing," "intentional" or "negligent" standard
  - ☐ Are SEC filings or other regulatory filings incorporated by reference?
- ☐ Who is an Insured for purposes of the Policy?
  - ☐ The Company
    - ☐ Subsidiaries
    - ☐ Sponsored non-profit organizations
    - ☐ Acquisitions
  - ☐ Past, Present and Future Directors
  - ☐ Directors emeriti, honorary directors, members of advisory panels
  - ☐ Past, Present and Future Employees
    - ☐ Temporary
    - ☐ Seasonal
    - ☐ Leased
    - ☐ Loaned
    - ☐ Employees of independent contractors
  - ☐ Volunteers
  - ☐ Other related persons including
    - ☐ Spouse
    - ☐ Domestic Partner

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- ☐ Heirs
- ☐ Estate
- ☐ Legal representative
- ☐ Assigns

☐ Are officers and directors serving as officers or directors of non-profit organizations covered?

- ☐ Is coverage limited to non-profit organizations which are tax-exempt under specific sections of the Internal Revenue Code of 1986, as amended?
- ☐ Must service be at the specific request and with the knowledge and consent of the company?
  - ☐ Does the company have documentation?

☐ What claims are covered?

- ☐ Written or oral demand for money damages or non-monetary relief
- ☐ Civil proceeding commenced by filing of a complaint
- ☐ Criminal proceeding
- ☐ Demand for arbitration, mediation or similar alternative dispute resolution
- ☐ Written request to toll or waive statute of limitations
- ☐ Formal administrative or regulatory proceeding commenced by filing of charges, formal investigation or similar document
- ☐ Costs relating to responding to:
  - ☐ Civil, criminal or regulatory subpoenas
  - ☐ *Wells* notice issued by SEC
  - ☐ U.S. Attorney Target Letter
  - ☐ Grand Jury Target Letter

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- ☐ Requests from regulators to provide information on informal basis or attend an interview or meeting
- ☐ Extradition

☐ Who has duty to defend a claim?

- ☐ The insured with an advancement of costs by the insurer
- ☐ The insurer

☐ What losses are covered?

- ☐ Defense costs, including appeals
- ☐ Actual damages
- ☐ Exemplary/punitive damages
- ☐ Multiple damages
- ☐ Pre-judgment interest
- ☐ Post-judgment interest
- ☐ Bonds on appeal
- ☐ Attorney fees and court costs assigned against the insured by settlement or court order
- ☐ Liquidated damages under the Age Discrimination in Employment Act or the Equal Pay Act
- ☐ Non-willful violations of the Foreign Corrupt Practices Act
- ☐ Sarbanes-Oxley 304/Dodd-Frank 954 costs (clawback provisions relating to executive compensation)
- ☐ Non-contestability of damages for violations of Sections 11, 12 or 15 of the Securities Act of 1933
- ☐ Shareholder derivative demand investigation costs

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- ☐ Insured vs. Insured Exclusion
  - ☐ Are there any exceptions from application of this exclusion?
    - ☐ Whistleblower claims
    - ☐ Cross-claims or third party claims for indemnity under the policy
    - ☐ Employment practices claims
    - ☐ Claims brought in sole capacity as a shareholder
  - ☐ Applicable to when an officer or director leaves his or her position with the insured and, if so, for how many years?
    - ☐ Is this provision applicable to any other specified person, eg. In-house counsel or chief risk officer?
- ☐ Illegal Profits/Fraud Exclusion
  - ☐ What standard is used?
    - ☐ Judgment or adjudication
    - ☐ Final adjudication
    - ☐ Final, non-appealable adjudication
- ☐ Does the policy contains a non-rescission provision?
- ☐ What is the standard adopted with respect to other insurance?
  - ☐ Regardless of whether collectible
  - ☐ Valid and collectible
- ☐ Claims reporting
  - ☐ What officers are covered?
  - ☐ Are officers of subsidiaries covered?
  - ☐ Is there an "extended" reporting period included?

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- ☐ Territoriality
    - ☐ Covers a claim which arises anywhere in the world
    - ☐ Covers a claim brought anywhere in the world
    - ☐ Covers only claims brought in a specific jurisdiction
- ☐ Side A Coverage
    - ☐ Coverage
        - ☐ All officers and directors
        - ☐ Only independent directors
        - ☐ Employees
    - ☐ Is it written as a Difference-in-Condition coverage?
        - ☐ Drops down to pay when traditional D&O doesn't pay due to an exclusion which exclusion is not present in the Side A policy
        - ☐ What non-indemnifiable losses are covered?
            - ☐ Insurer wrongfully refuses to indemnify
            - ☐ Insurer is financially unable to indemnify
            - ☐ Limits of liability of the traditional policy have been exhausted by reason of losses paid
            - ☐ Under the base D&O, the insurer is not liable for the loss (ie an exclusion applies)

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- ☐ Bankruptcy, liquidation, reorganization, rehabilitation or similar proceeding is commenced against the company and, as a result of such proceeding, the proceeds of the base D&O policy cannot legally be paid by the insurer
  - ☐ As a condition precedent, must the insureds request that the insurer petition the court for allowance to pay the covered loss from the base D&O policy?
- ☐ Is there a non-rescission provision?
- ☐ Does it include coverage for officers and directors serving as officers or directors of a non-profit organization?

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