

# Community Banks

## Dilute the Coffee, Not the D&O Insurance

By Kevin Rankin, CNA Insurance

I stopped by my local community bank last weekend and noticed that the complimentary Saturday morning coffee was freshly brewed, but it didn't seem to be up to the bank's usual gourmet standard. It is no surprise that as the economy worsens community banks are instituting numerous cost-cutting measures. Indeed, we may be beginning to see some privately held community banks dilute, or even cancel, their Directors and Officers (D&O) coverage in an effort to cut costs. Although it may be reasonable for management to cut back on customer perks, treating D&O coverage as a discretionary expense could have the unintended effect of impairing an institution's ability to attract and retain top management and Board level talent. In fact, given the current environment, it may become more important than ever to ensure you have comprehensive D&O coverage.

Litigation activity is almost certain to increase. According to "Securities Class Action Filings – 2008: A Year in Review", federal securities class action lawsuits filed in 2008 were up 19% from 2007, and almost one half involved financial services firms.<sup>1)</sup> While this statistic is unique to publicly traded financial institutions, it is reasonable to assume the overall level of litigation aimed at financial institutions, public or private, large or small, will continue to rise, given the dramatic proliferation of defaults and foreclosures. Indeed, one of the largest exposures facing community banks is the cost of defending a D&O lawsuit. Tillinghast-Towers Perrin, a global risk management firm, estimated the cost of defending D&O litigation can range from \$100,000 to \$2,000,000.<sup>2)</sup>

Contrary to popular belief, not all General Liability or Umbrella insurance provides coverage for litigation costs of common allegations like financial misrepresentations, breaches of fiduciary duties, or conflicts of interest. In the absence of D&O insurance, such litigation expenses (not to mention any damages awarded), would be the responsibility of either the institution or, if no indemnification agreement is in place, the Directors and Officers themselves. Because of the potential for personal liability, Directors and Officers can be expected to scrutinize an institution's D&O coverage. If the coverage is weak or nonexistent, current or prospective Directors and Officers may decide the personal risk is too great, leaving an institution handicapped in its efforts to attract and keep top talent.

There are a few important things to keep in mind when evaluating D&O liability insurance policies:

- First, a proper Management Liability program will allow for separate and dedicated limits for D&O and E&O coverages respectively. This is critical so limits available to the Directors and Officers are not eroded by Errors and Omissions losses.
- Second, banks should be wary of policy language which allows the insurer to cancel the D&O policy mid-term. Look for language that limits the circumstances the carrier can cancel due to nonpayment of premium. As this credit crisis deepens, we are beginning to see carriers abruptly severing contracts, citing material changes to the risk such as increased non-performing loans, high levels of commercial loans, or newly issued regulatory orders. Once uninsured, banks with documented operational or financial challenges could have difficulty finding adequate insurance coverage.
- Lastly, for extra piece of mind, qualified banks should consider adding additional Side-A D&O coverage to their existing policy. Side-A D&O insurance provides coverage to Directors and Officers if the bank is financially incapable or legally precluded from indemnifying them. Several

insurers now offer an automatic \$1,000,000 limit of Side-A D&O coverage for non-indemnifiable loss which is in addition to the primary limits already provided under the contract.

In this difficult economic environment it might make sense to water down the coffee, but now is not the time to be diluting your insurance protection.

<sup>1)</sup> Excerpted from Cornerstone Research 2008 Securities Class Actions Filing

<sup>2)</sup> Excerpted from Tillinghast-Towers Perrin 2001 D&O Liability Survey

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