Client Alert: Bank Director Indemnification and D&O Liability Insurance: New FDIC Advisory

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Statutory protections, indemnification and director and officer liability insurance (D&O insurance) all combine to provide some level of comfort and protection to bank directors in the proper performance of their duties as directors. The hope is that directors can begin and complete their terms of office knowing that these protections exist, but never having to call on the protections or their potential limitations.

However, these protections exist for a reason and every so often it becomes necessary to look to the protections when issues arise. The issue was recently revisited by the Federal Deposit Insurance Corporation (FDIC) in an advisory issued October 10, 2013, reminding institutions of the importance of reviewing appropriate director protections, including notably D&O insurance, and any limitations thereon.

Just as directors take care to ascertain that appropriate protections are in place for their personal and business risk exposure outside of the institution, these protections as bank directors should likewise be the subject of periodic review by bank boards that deal with the additional "risk" of bank-related civil litigation and governmental actions. The time to be reviewing and understanding the level of coverage provided under applicable law, indemnification, and insurance, and limitations on those protections, is not after a claim has been asserted.

Statutory Protections

In Ohio, directors have the good fortune of strong statutory protections when acting in good faith and in the best interests of their constituencies. The director standards in the Ohio Revised Code are some of the best state-law protections in the nation, and Ohio directors are fortunate that the Ohio Legislature has provided an environment where state law helps to protect directors in the appropriate performance of their duties as directors. Boards should receive ongoing education, however, to help directors understand the standards of performance expected of them when acting in their role as directors, where the law provides protection to them, and where it does not.

Indemnification

Ohio law also provides that institutions may indemnify directors for certain claims made against them when acting in their capacity as directors of Ohio business organizations, and boards should review their governance documents in order to ascertain that they are being provided indemnification to the extent provided by applicable law. Periodic reviews of governance documents to ascertain the level and extent of indemnification, and any limitations on indemnification coverage otherwise provided under applicable law, should be undertaken by the board so that directors understand the nature and extent of indemnification provided by the institution as well as any restrictions. And, since the law changes from time to time, so that governance documents anticipate and incorporate, if appropriate, updates and changes in applicable corporate law. There are regulatory limitations on indemnification for civil money penalties (CMPs) imposed by regulatory agencies, and regulators may in fact order institutions not to make indemnification payments as part of regulatory enforcement actions. Since indemnification involves potential payments directly by the institution, insolvency and bankruptcy of the institution can result in limitations on, or elimination of, indemnification coverage.

Director and Officer Liability Insurance

D&O insurance provides insurance backup in the event that claims arise that are subject to coverage under the policy. Purchase of D&O insurance is a standard practice in the banking industry, is part of risk mitigation and is important to attract and retain qualified directors. Like other insurance, it is subject to specific requirements for notice of claims, deductibles and limitations on coverage. And for banks, D&O insurance coverage, like indemnification, is subject to regulatory limitations.

On October 10, 2013, the FDIC published an advisory (FIL-47-2013) noting an "…increase in exclusionary terms or provisions in director and officer liability insurance policies purchased by financial institutions (that) may limit insurance coverage under certain circumstances, thereby increasing the potential personal exposure of board members and bank officers in civil lawsuits." The advisory also reminds directors and officers that the purchase of insurance to cover CMPs issued by regulatory agencies against institution-affiliated parties (which include directors and officers as well as others affiliated with insured depositories; "IAPs") is prohibited even in the event that the IAP agrees to reimburse the institution for the cost of coverage.

The FDIC advisory does not represent a new policy or change in law or regulation, and is not intended to serve as a scare tactic to discourage bank board participation. It is rather a straightforward reminder of current law and regulation on the topic and a reminder that directors should be cognizant of the protections in place for their service as well as limitations. Reductions in coverage and increases in premiums and deductibles have a history in the banking industry, which tends to follow periods of increased bank problems and litigation.

So What Now?

First and foremost, the FDIC advisory is not cause for panic and is not intended as a threat, but rather is a "heads up" for directors to remind them to be cognizant of their D&O coverage and aware of any limitations and cost considerations. Directors should be, and remain, aware of the protections in place for their service as well as any limitations or conditions with regard to those protections. In that regard,

directors should be educated as to not only the risks and available protections but the legal standards that apply to their service. That education should be coupled with a periodic review of board governance materials to ascertain that directors are in fact eligible for maximum protection under the law in the proper performance of their duties, and a periodic review of the terms and cost of D&O insurance coverage in place and available for the board and the institution's other IAPs if appropriate.

Those issues obviously receive heightened interest when an institution is "troubled", and in those instances (and hopefully before they arise) boards should undertake a close review of the foregoing issues to understand what protections are, and are not, in place. D&O insurance, in those instances, can become significantly more expensive and coverages may be reduced or eliminated, especially if the institution is in or near a renewal period. Care must be taken to carefully scrutinize claims requirements and other terms of the current and any renewal or extended policy, and to ascertain that coverage is not lost or somehow inadvertently waived.

It is important that directors know and understand the protections available to them in their service to the institution, and take care to review and update those protections and any limitations when and as appropriate. Some institutions operate under governance documents that have not been reviewed or amended for decades, and are not providing the kind of protections that the directors may imagine, expect or assume. Some institutions also operate with the same type and level of D&O insurance coverage in place for years, although their risk profile may well have changed. The time to undertake a comprehensive review of all these issues is not when serious problems are facing the board and it may well be too late, but rather the process should be an ongoing part the board's education process and review of governance materials (and various insurance coverages) so that the directors understand what protections are in place with regard to their service.

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