

WIB/AABD
Annual Directors Conference
November 14, 2009

Avoiding Director Liability – A Wake Up Call



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Introduction

- Bank failures are in the news, a weekly occurrence.
- Bank D&O insurance policies are being cancelled with great frequency and tightening of language and coverage.
- Cease and Desist Orders are proliferating.
- Bank examination reports are becoming highly critical of the Boards of Directors and management.



Introduction

- Disgruntled shareholders are becoming more aggressive and some are suing.
- The tailspin in the economy may not be entirely over.
- No clear end in sight to the deterioration of banks' financial condition.
- This is an environment in which potential liability of bank directors is heightened.



What we will cover

- Standard of care of bank directors under state and federal law
- Sources of liability – private vs. governmental
- Steps to avoid or mitigate the risk of personal liability



Standard of care for bank directors and conflicts of interest

- Good faith
- Care that an ordinarily prudent person in a like position would exercise under similar circumstances
- In a manner he or she reasonably believes to be in the best interests of the corporation
- Entitled to rely reasonably on others



Standard of care for bank directors and conflicts of interest

- Business Judgment rule
- Conflicts of interest
- Federal banking law
- Simple vs. gross negligence



Sources of Liability

- Shareholders and other private parties
- Bank regulatory sources
- SEC
- State attorneys general
- The Big Enchilada – when a bank fails



Steps to avoid or mitigate personal liability

- Creating a suitable corporate governance structure – Information, knowledge, structure, and attitude
- Appropriate board & committee organization
 - Risk committee
 - Audit committee
 - Compensation committee
- Charters (job description) & tracking compliance



Steps to avoid or mitigate personal liability

- Sufficient Board reports & documentation
- Bank regulator: “If it’s not written down – it didn’t happen”
- Sufficient board reports and information flow
- Identification of and resolution of red flags
- Value of new tools – Board Portals (like Diligent Board Books)



Steps to avoid or mitigate personal liability

- Limitation of liability in statute, charter and/or bylaws
- Indemnification provisions in statute, charter and/or bylaws
- Avoidance of conflicts of interest
- Avoidance of a bank failure
- Resignation



D&O Insurance



Market Conditions

A lot has happened in the last 12 months...

- Financial institution business, specifically banks, have gone into a hard insurance market:
 - Significant rate increases
 - Reduced capacity on limits
 - Increased retentions/deductibles
 - Tightening of terms
 - Changes in insurance company players
 - * Excess FDIC market has dried up
 - * Fewer insurance companies in the Financial Institution marketplace
 - Non-renewals



Market Driving Issues

So what's driving the issues ?

- * Recession
- * Poor financial results at many banks

Q2 2009 FDIC-insured institution notables:

- > \$3.7 billion in net operating loss
- > 28.3% of institutions are unprofitable
- > Avg. Non-performing loan rate @ 4.35%
(U/W Benchmark under 3 %)
- > 416 banks on “Problem List”



Market Driving Issues

So what's driving the issues...

Bank Failures

- > 25 in 2008
- > 115 YTD 2009 (as of 10/30/09)
- > More to come

Uptick in claims activity for carriers insuring banks

- > “Long Tail” business it could take 3 to 5 years for full extent of a claim to be known.
- > Reinsurance carriers are getting tough, they are demanding tighter terms and conditions.



Contract Expectations

What should you expect from your carrier?

- > Premium increases
- > Potential limit reductions
- > Potential retention/deductible increases
- > Potential tightening of terms and conditions
 - * Example: Regulatory exclusions if you are under an MOU, C&D etc.
- > Potential non-renewal if the bank is in poor financial condition.



Underwriting Issues

What are carriers focusing on?

- * Financials

- > Capital

- > Asset quality

- * Heavy concentration of construction and commercial real estate loans

- * Non-performing loans

- * 30 to 89 day delinquencies (slow pay)

- * Earnings

- * Liquidity

- * Brokered deposits

- * Loan to deposit ratio

- * Investment portfolio



Underwriting Issues

What are insurance carriers focusing on?

> Claim Experience

- * Frequency vs. Severity

> Management (Officers & Directors)

- * Qualified & Experienced

- * Checks & Balances

- * Knowledge of Banking Operations & Industry

- * Conservative Management Approach



Addressing the Renewal Process

How to make the renewal process smoother

- > Periodically market your bank's coverage
- > Submit renewal information as soon as possible
 - * Giving your underwriter more time can help their comfort level.
- > Conduct underwriting meetings
 - * Meet "in person" with underwriters
- > Don't carry more limits than you need
- > Take on more risk
 - * Higher deductibles may help cost



Renew Process

So what happens if you face the potential of non-renewal?

> Management should evaluate your exposure

- * Do you have knowledge of a potential claim?
- * Put your carrier on notice of a potential D&O claim ASAP!!! (Claims Made Policy)
- * Consider buying an Extended Reporting Period.

You can possibly buy up to 6 years of ERP

> Management should weigh the cost to buy the ERP vs. the comfort level you have with your exposure.



Questions?

