Outsourcing Community Bank Management Functions

What Happens When You Sell

By Joseph Scully

At a community bank, the CEO, COO and CFO wear many hats. They run the day-to-day operations, deal with regulators, keep the board of directors up to date on management issues, hire and fire employees, oversee lending – the list goes on. Because these entities often do not employ risk managers to sculpt their insurance programs, they might rely on their insurance brokers to help them understand the risks peculiar to community banks, and buy appropriate insurance products to cover them. What bank directors and officers do not always grasp is the host of new risks that come up when their bank merges with another bank or is acquired. When a bank outsources management functions, these risks can multiply fast.

Some banks, looking for creative ways to cut costs, contract out chunks of their overhead to vendors offering a menu of services from human resources to risk management to insurance placement, providing a one-stop shopping solution for many fixed expenses that do not justify dedicated employees. These vendors, known as professional employee organizations, or PEOs, bundle and cross-sell these services to create packages attractive to smaller companies wanting to stay lean. There can be good financial reasons for buying these services. But outsourcing senior management-level decision-making can put a bank at risk of delegating important calls to a contractor that lacks access to the big picture. Moving

Continued next page

human resources directors, risk managers, payroll managers and other management and administrative functions off premises can be a good value proposition where the bank supervises PEOs at the highest level of the company. If it does not do so, modeling enterprise and liability risk is tough to do, and shifting these risks to other outlets – like insurance programs – can be tricky.

> *"After a bank is sold . . . buyers tend to pare back staff to achieve an economy of scale, leaving long-term employees on the street with scores to settle."*

Leasing employees is nothing new, but some PEOs are now offering broader services, including master insurance policies (e.g., workers' compensation, fiduciary, employment practices liability, crime, directors and officers, health and disability) covering banks either directly without a broker, or through the PEO with only the vendor's broker available to meet the bank's individual needs. The enhanced bargaining and buying power PEOs offer their clients can make this a good deal. But community banks should pay close attention to what PEO insurance programs do not cover, particularly when a bank is planning to merge with or be acquired by another financial institution. Directors and officers of smaller banks with PEO-originated insurance, who are considering a merger or acquisition, should think about the following issues.

1. Before closing any sale or merger, any and all actual or potential claims need to be reported under the PEO's insurance policies. Insurance companies take a dim view of preclosing claims not reported until after the deal is done, and bake coverage defenses into their policies to avoid them. As part of due diligence, many times a seller must represent and warrant to the buyer that all circumstances potentially giving rise to claims have been disclosed to the surviving entity. Breaches of these representations and warranties can carry consequences beyond just losing insurance coverage – the purchase price may be adjusted, or hold-backs forfeited, as a result of undisclosed claims. If the selling bank ceases to exist at closing, its directors and officers can face post-transaction claims by third parties that the buyer may not be willing to indemnify. Making sure applicable directors and officers (D&O) liability, employment practices liability (EPL) and similar insurance policies are in effect after the seller is merged out or sold is critically important to protect against these liabilities – which plaintiffs may try to pin on the seller's former directors and officers personally.

2. A D&O policy protects the bank and its directors and officers from liabilities they incur from performing their duties for the entity. ELP insurance often protects the bank, its management and its board from liabilities to employees and third parties arising from termination of employment, discrimination, harassment and similar offenses. Coverage under these kinds of policies is not triggered by the date the policyholder committed the allegedly bad acts. Rather, depending on the kind of policy, coverage is triggered either when a qualifying claim is made against the policyholder (in the case of a "claims made" policy), or when a claim is made against the policyholder and reported to the insurance company (in the case of a "claims made and reported" policy). Because both kinds of insurance may disappear when the bank is sold, a claim made against an individual director or officer of the seller after closing, based on preclosing acts or mistakes, may not be covered.

Moving On

After a bank is sold, its directors and officers look for new jobs and go on with their lives, secure in the knowledge that the business of the bank they used to serve is over and done with. This may not be so. Buyers tend to pare back staff to achieve an economy of scale, leaving long-term employees – who may watch directors and officers leave with golden parachutes – on the street with scores to settle. Disgruntled shareholders may file suit over perceived unfairness in the transaction. Where the sold bank is merged out, or is bought on an asset rather than stock basis, the entity itself is protected against such future claims based on preclosing acts because the seller bank is gone, never to return. But its directors and officers usually are very much alive. If claims are asserted against them months or years later for liabilities incurred before the sale, they may not be covered unless – as a term of the sale – the buyer purchased an extended discovery period on D&O, EPL and similar policies (known as a "discovery tail") covering the individuals for post-closing claims.

These policies typically offer discovery tails automatically, on payment of an amount measured by some multiplier of the final year's premium. But PEO master policies do not always offer discovery tails, much less automatic ones. If directors and officers rely upon a PEO to provide risk management and insurance procurement services, and sell their bank without buying an extended discovery period, any claims made later concerning presale events may not be covered. This might take the shine off of bargain premiums, particularly when directors' and officers' personal wealth is threatened because a key part of any merger or acquisition – ensuring insurance protection of outgoing management and board members – was outsourced.

On Your To-Do List

Finding solutions for this kind of potential coverage gap, to prevent unpleasant surprises if claims arise after sale, should be part of the due diligence task list. Directors and officers of a bank using a PEO should ask the vendor to find them tail coverage for a period of years after closing recommended by legal counsel. If the PEO cannot deliver a tail, they should ask an independent broker (i.e., not the one sponsoring the PEO master policies) to recommend alternatives.

Another option for enhancing PEO-furnished coverage may be excess coverage. Many PEO policies are written with low limits. Careful banks purchase additional layers of D&O and EPL insurance to increase the overall limits or, just as important, drop down to the primary level if the PEO policy does not cover a loss. A discovery tail may be purchased on excess policies to enhance post-closing protection.

Another possible solution is contractual indemnity, backed by the buyer's own insurance programs. If possible, the seller should negotiate an indemnity agreement with the buyer providing a contractual source of payment of claims against directors or officers after the deal closes. This shifts the burden of insuring these risks to the buyer. But what if the transaction is a fire sale? What if the seller has no ability to negotiate, and must take what the buyer offers? If the seller will not provide indemnity for post-closing claims, and no insurance is available, the directors and officers should first ask their PEO what it recommends. If it has no available options, they should seek the advice of a broker unrelated to the PEO able to offer self-financed insurance solutions.

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PEO policies often furnish commoditized, bargain-priced insurance policies that may be appropriate for a bank with no special needs, but inappropriate for a bank involved in a merger or acquisition. The practice of outsourcing management functions is here to stay. But a bank about to change hands must do its own assessment of the risks likely to survive the deal. Relying on the sponsoring broker or PEO to offer advice and insurance products tailored to the needs of individual directors and officers may not be prudent. There is a wide margin for error in bank mergers and acquisitions, and one-size-fits-all insurance policies may not yield the protection from future liability that management and the board expect. ▲

Joseph Scully is president of Financial Guaranty Insurance Brokers.