Financial Guaranty Insurance Brokers, Inc.

When Directors are Sued, Who Pays?

Whatever directors do, someone may say they should not have done so. Whatever they do not do, someone may say they should have done so. Monday morning quarterbacks abound. Hungry lawyers are not far behind them.

Directors and officers of banks may expect to be sued, but they do not expect to pay - not in return for a small annual fee for sitting on a board. They expect the corporation or Insurance Company to pick up the tab.

Where does the litigation come from?

- Employees 40%
- Shareholders 35%
- Customers 20%
- Other 5%

Mergers, acquisitions and stock offerings are frequent causes of claims against bank directors and officers. Inadequate or inaccurate disclosure including, financial reporting are the most frequent allegations in shareholder claims. Many of these disclosure claims are due to alleged violations of Section 10(G) of the 1934 S.E.C. Act. This litigation relates to securities trading decisions which have led to financial loss, or loss of financial opportunity due to inadequate or inaccurate disclosure.

Other causes of action against directors which may result in substantial cost are due to negligent oversight of management, conflict of interest, self dealing, and bank regulatory agency complaints.

Discrimination in employment is the most frequent cause of litigation against the corporation and its directors and officers. Discrimination is not necessarily related to race, gender or religion. These factors are usually included in a claim of discrimination, if they will enhance the claimant's cause.

Wrongful Termination is another frequent cause of action alleged by former employees.

Constructive Termination usually infers that a failure to promote, or a transfer to a position of equal or lower status equates to an improper job evaluation due to inaccurate information, or prejudice, placing a lid on advancement or pressure to force a resignation. It is more difficult for a plaintiff to succeed in this situation.

Sexual Harassment some how or another weaves its way into many of the employment related lawsuits. Due to the heavy social impact of these accusations, the circumstances can become personally devastating to the accused person and corporation, adding pressure to placate or settle financially, so often undeservedly.

The recent news of the Enron collapse resulting in accusations of improper corporate and personal behaviors, scandal, bankruptcy and potential criminal acts, has heightened the awareness of the need for thorough and accurate accounting and financial disclosure. This has made clear the responsibilities of the director to make sure that the financial information received from the outside auditor, the CFO and the CEO is a full revelation of all the pertinent information necessary to understand the financial condition of the bank.

The cost to defend D & O claims whether or not the allegations of the plaintiff are legitimate, or the demand for settlement is justified, can be very high. If a settlement or judgment ensues, the cost can be in the thousands to millions depending on the legitimacy of the allegations and the circumstances of the claim.

How does the director get protected?

Corporate Indemnity is the first step, wherein the corporation agrees pay for the cost of defense and/or any settlement of litigation involving a member of the board of directors. The corporation should have legal counsel draft this agreement, and then have the board of directors, approve it.

This protection is a normal consideration granted to the members of the board.

Should a director or former director fall out of favor with the board, there is the risk of this agreement being ignored or denied by the board, forcing the director to seek legal action to enforce this recovery. Especially when a sale or merger occurs, and the directors of a former corporation find themselves subject to an indemnification agreement granted by the nonexistent entity, they have no protection unless they have D & O Tail Coverage in place. This extension of D & O insurance may be purchased prior to a merger or sale for up to six years, which is the term of the Statute of Limitations in many states.

Virtually 100% of banks in the country purchase D & O insurance. Not all of these contracts are alike. Originally, the insuring agreement covered only directors and officers. Now all employees are covered. The corporation itself may be included. It is vital to do so. If there is litigation involving the directors, the corporation will almost always be named too. If the entity is not insured, but is involved in the litigation, allocation of the cost of defense and a settlement will usually be determined with a 50-50 split. If the directors are dismissed from the lawsuit under this scenario, there would be no further insurance coverage for the corporation. That is why Entity Coverage is necessary to avert this alarming shock of " No Coverage" for the corporation.

The D & O broker should present quotations which include these insuring options:

- Entity Coverage (Includes Corporation)
- Bankers Professional Liability (Includes Insurance, Investments, Escrow, Trust, ETC.)
- Lender Liability (Suits by Borrower)
- Employment Practices Liability
- Internet Liability

The D & O insurance market is stable with prices on the rise 10% to 20% for renewals this year. The financial strength of the insurer is most important. There are household names, which represent the highest financial strength. There are other insurers, which are not heavily capitalized, which rely upon reinsurance to limit their retention of risk. To properly evaluate a proposal for D & O insurance the insurer, the terms of coverage offered, the premium charged, and financial strength of the insurer must be considered.

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