Bloomberg BNA

BNA's
Banking Report™

Reproduced with permission from BNA's Banking Report, 102 BBR 432, 3/11/14, 03/11/2014. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

ENFORCEMENT

Must-Know D&O: Lessons from FDIC Guidance and Case Law on D&O Insurance

BY MATTHEW DYCKMAN, SAMANTHA M. KIRBY, CARL E. METZGER AND SHOAIB A. GHIAS

I. Introduction

The Federal Deposit Insurance Corporation (FDIC) recently warned financial institutions that it has observed an increase in exclusionary terms contained in the director and officer (D&O) insurance policies of depository institutions.[1] The FDIC emphasized the importance of ''appropriately structured'' D&O insurance coverage to the safety and soundness of depository institutions and encouraged directors and executive officers to understand the answers to several key questions regarding their institution's D&O insurance coverage. Translation: directors must be proactive in ensuring that they are properly advised about the scope of their insurance coverage, and that they then provide appropriate oversight to ensure that the bank secures a strong coverage program in light of what currently is available in the D&O insurance marketplace. As institutions gear up for another examination cycle, directors and executive officers would be well served to examine not only their bank's D&O insurance coverage, but also the bank's corporate governance documents in light of the FDIC guidance and several recent court decisions.

II. FDIC Guidance

On Oct. 10, 2013, the FDIC issued an ''Advisory Statement on Director and Officer Liability Insurance Policies, Exclusions and Indemnification for Civil Money Penalties'' (the Advisory Statement). In the Advisory Statement, the FDIC acknowledged the importance of D&O insurance to financial institutions both as a risk mitigation tool and as a means to attract and retain qualified directors and officers. The FDIC stated that ''[a] basic principle underlying the use of director and officer (D&O) liability insurance is that financial institutions (as well as depositors and shareholders) are best served by knowledgeable directors and officers who make carefully considered strategic risk decisions on behalf of the institution.''[2]

Matt Dyckman (counsel) and Samantha Kirby (partner) are members of Goodwin Procter's Financial Institutions Group, with extensive experience in corporate finance and securities, mergers and acquisitions, and banking and financial services. Carl Metzger is a partner in the firm's Business Litigation Group and leads the firm's Risk Management & Insurance practice. Shoaib Ghias is an associate in the firm's Business Law Department.

[1] Advisory Statement on Director and Officer Liability Insurance Policies, Exclusions and Indemnification for Civil Money Penalties, FDIC FINANCIAL INSTITUTIONS LETTER, FIL-47-2013 (Oct. 10, 2013).

[2] Id.

The FDIC then noted that an increase in exclusionary provisions contained in D&O insurance policies may adversely affect the recruitment and retention of well-qualified individuals: ''When such exclusions apply, directors and officers may not have insurance coverage and may be personally liable for damages arising out of civil suits relating to their decisions and actions.'' The FDIC explicitly stated that it was concerned that directors and officers were not always ''fully aware of the addition or significance of such exclusionary language'' and emphasized that directors had a responsibility not only to understand such policies but to choose D&O insurance coverage ''based on a well-informed analysis of costs and benefits'' with an important consideration being ''the potential impact to directors and officers that could result from exclusions.''[3]

To address this concern, the FDIC urged directors and executive officers of financial institutions to fully understand the answers to the following questions regarding D&O insurance coverage, especially when considering renewals and amendments of existing policies:

- What protections do I want from my institution's D&O policy?
- What exclusions exist in my institution's D&O policy?
- Are any of the exclusions new, and if so, how do they change my coverage?
- What is my potential personal financial exposure arising from each policy exclusion?[4]

Finally, the FDIC reminded institutions that ''FDIC regulations prohibit an insured depository institution or depository institution holding company from purchasing insurance that would be used to pay or reimburse an institution-affiliated party (IAP) for the cost of any civil money penalty (CMP) assessed against such person in an administrative proceeding or civil action commenced by any federal banking agency'' and that the ''regulations do not include an exception for cases in which the IAP reimburses the depository institution for the designated cost of the CMP coverage.''[5]

It is likely that the Advisory Statement was prompted by a concern that so called ''regulatory exclusions'' - policy provisions that prevent financial institutions from recovering on claims arising from proceedings brought by federal or state banking regulators were becoming more common as a result of the financial crisis. A regulatory exclusion would have the effect of precluding the FDIC, as the receiver of a failed bank, from collecting insurance proceeds in actions brought by it against directors and officers of failed banks. Whatever its motivation, the Advisory Statement provides useful, practical advice to financial institutions.

III. Reviewing Your D&O Insurance Policy

Rest assured, the FDIC is not expecting that every bank director and executive officer to become an expert on the intricacies of D&O insurance. Rather, the goal appears to be that a bank's leaders are properly advised about the scope of their insurance coverage, and that they then provide appropriate oversight to ensure that the bank secures a strong coverage program in light of what currently is available in the D&O insurance marketplace.

D&O insurance generally provides coverage for judgments, settlements and defense costs incurred in connection with the defense of a claim against a director or officer. D&O insurance policies, however, are not created equal. There is no standard form, and the scope of coverage can vary among insurance carriers.

Further, unlike some other forms of insurance, D&O insurance policy terms often can be modified by negotiation to broaden the coverage – if you know what enhancements to ask for. In addition to regulatory exclusions, which are discussed above, other avoidable pitfalls include ''insured versus insured'' exclusion. A recent case involving the FDIC illustrates this point.

A federal court in Georgia recently held that an exclusion in the D&O insurance policy of a failed bank barred insurance coverage in a lawsuit being brought by the FDIC, in its capacity as receiver of the failed bank, against two officers of the failed bank.[6] The failed bank's D&O insurance policy included an insured versus insured exclusion, which barred coverage for claims brought or maintained by or on behalf of any insured person or entity ''in any capacity.'' The court noted that the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and prior case law have established that (1) the FDIC ''stands in the shoes'' of a failed bank and (2) any defenses that defendants could successfully have raised against the failed bank can be raised against the FDIC in an action by the FDIC as receiver for a failed bank.[7] Accordingly, because the ''insured versus insured'' exclusion would have barred coverage for claims by the failed bank against the officers, the exclusion also barred coverage for claims by the FDIC against the officers.[8] While insured versus insured exclusions are common in D&O insurance policies, a well-advised board working with knowledgeable outside counsel and insurance brokers can be successful in carving back the scope of such an exclusion.

Finally, the reputation for claims-handling expertise and fairness can vary by carrier, so it is important to be adequately advised on this front as well.

With these points in mind, bank directors should plan on overseeing a review of their institution's D&O insurance program. The senior officer responsible for the D&O insurance procurement process can take the lead in managing this review, but the directors themselves should provide active oversight of this process, and should expect – and, if necessary, demand – a report and the opportunity to ask questions to probe the adequacy of the review and of the underlying D&O insurance coverage program. In our experience, outside counsel, working together with a knowledgeable broker, can play a critical role in this process, assessing whether the program's terms and conditions offer com-

---

[3] Id.
[4] Id.
[5] See 12 U.S.C. § 1828(k)(6) and 12 C.F.R. § 359.1(l)(2)(i).

[6] *St. Paul Mercury Ins. Co. v. Miller*, 2013 BL 219372 (N.D. Ga., Aug. 19, 2013).
[7] *Miller*, 2013 BL 219372, at *5, citing *O'Melveny & Myers v. F.D.I.C.*, 512 U.S. 79, 86 (1994) and 12 U.S.C. § 1821(d)(2)(A)(i).
[8] *Miller*, 2013 BL 219372, at *5. Other courts have held that an ''insured versus insured'' exclusion does not apply to the FDIC in its capacity as receiver of a failed bank. The FDIC is appealing the decision.

 COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0891-0634

petitive coverage and have been negotiated by an experienced D&O insurance brokerage, and serving as a resource to the directors and senior officers to explain, in layman's terms, how the coverage works, what exclusions apply, and what options the bank has to improve its coverage program.

While insurance typically is not anyone's favorite topic, a review and assessment of a bank's D&O insurance program should lead to the directors and senior officers feeling both better informed and, most importantly, better protected against the risk of personal liability for actions they may take on behalf of their institution.

IV. Indemnification and Advancement Provisions in Governance Documents

It is not sufficient for directors and executive officers to exclusively rely on D&O insurance coverage. A review of a bank's corporate governance documents, particularly the indemnification provisions of its charter and/or bylaws, is also crucial to ensuring that directors and executive officers are adequately protected from liability. Properly drafted indemnification provisions also protect the bank. Corporate bylaws and state statutes often require companies to indemnify directors, officers and employees for legal fees incurred by individuals in defending themselves for actions taken in their capacities as directors, officers or employees. Since the beginning of the financial crisis, financial institutions and their officers have faced a wave of private litigation and governmental investigations alleging mortgage fraud, insider trading, securities fraud, money laundering and other serious civil and criminal charges. This wave of litigation has forced financial institutions to decide whether they are required to indemnify (and/or advance) employees for legal fees and costs incurred in defense of such litigation. When reviewing the indemnification and advancement provisions of corporate bylaws, the board must balance whether (or under what circumstances) the interest of attracting and retaining qualified directors and officers is outweighed by the interest of protecting the company and its shareholders against spurious indemnification or advancement claims. A recent case highlights the importance of finding the correct balance.

The Goldman Sachs Group, Inc. was recently ordered to advance the legal fees of a former employee of one of its subsidiaries accused of stealing thousands of lines of confidential source code for high-frequency trading software.[9] After the employee's conviction in federal court was overturned on appeal,[10] the employee, Sergey Aleynikov, was indicted on similar charges in New York state court. Mr. Aleynikov then sued Goldman Sachs in federal court for (1) indemnification for legal fees and costs arising from his successful defense in the federal case; (2) advancement of legal fees and costs for his defense in the state case; and (3) advancement of legal fees and expense incurred in seeking indemnification and advancement. While Goldman Sachs may eventually be entitled to recoup the advanced funds if Aleynikov is convicted in the state court proceeding and/or if Goldman Sachs prevails in its counterclaims, during the interim period (which could last several years), it will be forced to advance legal fees to pay for the defense of a former employee accused of committing a criminal act against it.

Mr. Aleynikov's claims were based on Goldman Sachs's bylaws, which read as follows:

"The Corporation shall indemnify to the full extent permitted by law any person made or threatened to be made a party to any action, suit or proceeding . . . by reason of the fact that such person or such person's testator or intestate is or was a director or officer of the Corporation, is or was a director, officer, trustee, member, stockholder, partner, incorporator or liquidator of a Subsidiary of the Corporation . . . Expenses, including attorneys' fees, incurred by any such person in defending any such action, suit or proceeding shall be paid or reimbursed by the Corporation promptly upon demand by such person and, if any such demand is made in advance of the final disposition of any such action, suit or proceeding, promptly upon receipt by the Corporation of an undertaking of such person to repay such expenses if it shall ultimately be determined that such person is not entitled to be indemnified by the Corporation."

The judge determined that Aleynikov, who had the title of vice president, was an officer of the company as that term is understood in the bylaws and ordered Goldman Sachs to advance (1) reasonable fees and expenses incurred to date in Aleynikov's legal defense in the state case; (2) reasonable fees and expenses that Aleynikov incurs for his ongoing defense in the state case; and (3) "fees on fees," i.e. legal fees and expenses incurred by Aleynikov in attempting to enforce his advancement rights.[11] The rationale for the ruling was based in large part on Delaware's "strong statutory policy favoring advancement of fees and expenses," which the court noted was "both time-sensitive (the funds are needed in pending legal proceedings now) and provisional (the funds must be paid back if plaintiff is not successful)" compared to indemnification where "neither is true."[12] In fact, the indemnification provisions in the bylaws of Goldman Sachs did not cover fees on fees, but the court relied on Delaware's case law that holds that indemnification includes fees on fees unless explicitly excluded in the bylaws.[13]

On its face, the *Aleynikov* lawsuit appears to be a run-of-the-mill indemnification and advancement case.

---

[9] *Aleynikov v. Goldman Sachs Grp., Inc.,* 2013 BL 291074 (D.N.J., Oct. 16, 2013).

[10] *United States v. Aleynikov*, 676 F.3d 71 (2d. Cir. 2012). Mr. Aleynikov was convicted of several federal criminal offenses in 2010 and sentenced to 97 months in prison, but his conviction was later overturned by the U.S. Court of Appeals for the Second Circuit on the grounds that, while he had breached his confidentiality obligations to Goldman Sachs, his conduct did not fall within the scope of the charged federal offenses.

[11] The judge denied summary judgment on the indemnification claims and, in essence, deferred any ruling on such claims pending further discovery and litigation of Goldman Sachs's counterclaims.

[12] The *Aleynikov* court noted the important distinction between indemnification and advancement. "There is a fundamental distinction between indemnification and advancement. Indemnification is a claim for fees incurred in a case that has already concluded in a plaintiff's favor; it is a claim for damages based on events concluded in the past. Advancement of fees, on the other hand, is designed to fund an ongoing case, and the recipient of the funds is required to pay them back should he be unsuccessful in that case."

[13] *Stifel Fin. Corp. v. Cochran*, 809 A.2d 555 (Del. 2002).

However, unlike other high profile instances of corporate indemnification and advancement of legal fees and expenses, Goldman Sachs was the intended victim of the alleged criminal activity and was being asked to indemnify an officer for legal fees and expenses incurred in a criminal proceeding being brought, in part, to protect its rights. Accordingly, banks would be prudent to re-examine the indemnification provisions in their bylaws (or charters) focusing on the following points:

■ *The Law Favors Indemnification and Advancement*. Section 145 of the Delaware General Corporate Law strongly favors indemnification and advancement and will be interpreted broadly by courts. While broad protections may be necessary to attract and retain qualified officers and directors, boards of directors must take care to ensure that the indemnification and, in particular, advancement provisions of bank bylaws are drafted in a manner that protect not only directors and officers but also protect the bank and its shareholders against spurious claims.

■ *Ambiguity Will Be Used Against You.* Under Delaware law, corporate governance documents such as charters and bylaws are interpreted in the same manner as other contracts. Absent ambiguity, their meaning is determined solely by reference to their language. However, ambiguity will be interpreted against the drafter, or in other words, against the bank.[14]

■ *Be Careful Who You Cover*. Banks should consider who is covered by the indemnification and advancement provisions of their bylaws. In our experience, the bylaws of some banks cover directors and officers only, while others also cover employees and agents. While the assurance of indemnification and advancement is critical to attracting and retaining directors and officers, such coverage is not typically as important to hiring and retaining talented employees. However, if banks want to provide such coverage, they should consider retaining discretion in the matter to avoid the result in *Aleynikov*. They can also consider exclusions for advancement of fees on fees. Furthermore, banks can limit indemnification and advancement provisions in bylaws to directors and officers, but utilize separate indemnification agreements to help attract and retain important non-officer employees.

■ *Precision Drafting Protects the Bank*. Banks should carefully evaluate how terms such as ''officer'' are defined in the bylaws. The bylaws of many banks do not define the term officer, opening the door to judicial interpretation ignoring the industry's practice of title inflation (or courtesy titles). For those bylaws that define the term officer, greater precision is needed to ensure that they cover only the intended officers. For example, Goldman Sachs defined the term officer in its bylaws as someone appointed by the board of directors. But for a non-corporate subsidiary such as Goldman Sachs LLP, where there was no board of directors, the bylaws provided that the term officer ''shall include in addition to any officer of such entity, any person serving in a similar capacity or as the manager of such entity.'' The court construed this circular definition of the term officer in favor of Mr. Aleynikov who enjoyed the title of vice president.

[14] *Aleynikov*, 2013 BL 291074, at *19.

■ *Board Discretion May Be Advisable*. Banks should reconsider whether indemnification and advancement provisions should be mandatory or permissive. When such provisions are mandatory, a corporation is obligated to provide indemnification and advancement, but when the provisions are permissive, the board of directors maintains the discretion to determine whether indemnification or advancement is appropriate based on the facts and circumstances of the particular case. In our experience, most but not all financial institutions have mandatory indemnification provisions. From the perspective of attracting and retaining directors and officers, mandatory provisions assure the prospective directors and officers that their business judgment will not be second-guessed by the board before coverage is extended. Nevertheless, banks may want to consider excluding certain more egregious acts from mandatory coverage, such as where the bank is the intended victim of a criminal act . To provide procedural safeguards for the indemnitees, bylaws can provide that coverage would be denied only when the board unanimously determines that the act falls into such a category.

■ *Consider the Scope of Advancement*. In general, advancement of expenses is conditioned upon an undertaking of having acted in good faith, but not upon the ability to repay. In the bylaws of many (though not all) financial institutions, advancement extends to appellate proceedings even after an indemnitee is found guilty of having acted in bad faith in the initial proceeding. We concede that the ability to repay should not be a condition for advancement in general. However, if an indemnitee is convicted of a crime against the bank, the board should evaluate whether advancement for appellate expenses should be conditioned upon an ability to repay or an approval of the board.

■ *Take A Position on Fees on Fees*. Banks should evaluate whether silence on ''fees on fees,'' i.e. fees and expenses incurred in attempting to enforce indemnification and advancement rights, in their bylaws would have the intended effect under the jurisdiction. For example, under Delaware's case law, indemnification of expenses includes fees on fees when the bylaws are silent, but under New York's case law, indemnification of expenses excludes fees on fees unless explicitly provided for in the bylaws.[15] The bylaws of Goldman Sachs did not include fees on fees, but the corporation was mandated to pay fees on fees in *Aleynikov* under Delaware's broad construction of expenses.

V. Conclusion

The FDIC's Advisory Statement and recent case law underscore the importance of periodically reviewing a bank's D&O insurance coverage and bylaw provisions. There is no one-size-fits-all solution when it comes to D&O insurance coverage and indemnification and advancement provisions in bylaws; therefore, directors and officers of banks should confer with their bank's risk managers and seek the advice of outside counsel when necessary to stay abreast of the evolving regulatory and corporate governance landscape. In this regard, we recommend that directors receive, at least

[15] *Stifel*, 809 A.2d 555; *Baker v. Health Mgmt. Sys., Inc.*, 98 N.Y.2d 80 (2002).

 COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0891-0634

once per year, a presentation from counsel or the bank's risk managers on the bank's existing D&O insurance coverage program and what currently is available in the D&O insurance marketplace. Waiting until a crisis arises to fill the gaps in insurance coverage or fine-tune bylaws provisions is not practical, as D&O insurance providers often decline to enhance or expand coverage for a failing institution and amendments to bylaws cannot have retroactive effect. In order to ensure that a bank is adequately protected, directors and officers should review insurance coverage and indemnification and advancement provisions during the calm before the storm. When the storm clouds are gathering, it is likely too late.