SELLING YOUR BANK? COVER YOUR TAIL WITH A 'TAIL'

Selling, buying, or growing, make sure board and officers suffer no undue exposure

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By Steve Cocheo, executive editor

You can't sell your way out of potential trouble. You can only do your best to protect yourself from liabilities as a bank officer or board member before and after sale or merger of your bank.

Regulatory fatigue; troubled portfolios with long odds and short agency deadlines; and demanded capital that isn't materializing all play their part in convincing some boards and managements that it is time to sell. Others simply want to cash out and move on. And a not insignificant number of continued optimists see opportunities in seeking a combination, and being part of a larger organization. We recently heard of a pending deal involving multiple community banks that will come together in hopes that there is strength, and regulatory relief of a sort, in numbers-that is, going from several to one.

In all cases, the deal takes on a life of its own and can crowd out other, important thoughts, such as, who covers the directors and officers after the bank that used to indemnify and insure them goes away. Board members and officers, focused on shareholder interests, need to remember self-protection, suggests attorney Jim McAlpin, and insist on insurance.

"You'll negotiate for indemnification by the acquirer," says McAlpin, partner at Bryan Cave, Atlanta. "But I like to see that indemnification backed up by [D&O] insurance."[Editor's Note: McAlpin wrote an excellent article on this website earlier this year concerning D&O insurance. Read his "How Good Is Your Bank's D&O Policy?")

Don't adopt a "hat in hand" attitude. "In significant acquisitions," continues McAlpin, "the cost of this insurance is often a rounding error." Even in a smaller deal, boards and managers must keep in mind protection for themselves, as well as employees, as D&O insurance may also cover staff members sued in their role as bank representative.

Two sets of needs must be addressed. First is the director or officer who will be leaving the organization after the deal. Second is the officer or board member who is staying on in some capacity. The former parties want protection for issues involving their work at the old bank. The latter want coverage going forward, in addition to the coverage for their old work, and they will be looking to two different carriers and two different policies, typically.

"Someone always owns the risk," observes Chris Taylor, head of Financial Institutions, Zurich North America. "Disputes can arise when there is overlap of directors and officers (old entity and new entity) and policies (extended policy and new entity policy)."

What all selling directors and officers need

Understanding post-merger coverage for work done for the old bank (or the bank before ownership changed hands) hinges on understanding two timing issues.

First, understand that the D&O policy of the acquired institution will most likely stop covering the insureds for any new activities the minute the merger is completed, according to attorney Jim McAlpin. The coverage of "live action," so to speak, stops as of the effective date of the merger. Period.

However, this is not the end of the story, explains Mike Read, marketing and sales manager at ABA Insurance Services D&O program (American Bankers Mutual Insurance, Ltd.). Legal issues arise from events predating the acquisition and may come up later. For this a bank typically has the contractual right to purchase an "extended discovery period," also known as an "extended reporting period." (This will have been negotiated at the time the entire policy was agreed to by bank and carrier. The cost may run from 75% to 250% of the original policy premium.) During the post-merger period purchased, the insureds can continue to put the carrier on notice of issues, or potential issues, that could trigger coverage. Read says this tends to result in laundry lists of possibilities being submitted to carriers under "notice of circumstances" provisions of D&O policies, just in case they turn into lawsuits that would be covered.

Again, the timing issue is such that the triggering event or events still must have taken place when the policy was in effect, before the merger.

Now, the carrier's contract will not have given the insureds the right to purchase unlimited extension of the reporting period. Attorney Jim McAlpin, for example, likes to see the acquirer purchase three to seven years of extended reporting for the seller's insureds, in order to provide coverage under statutes of limitations periods for claims. This will require negotiation first between the target and the buyer and then with the target's carrier. Read explains that carriers regard extended reporting periods as an annual exposure, so pricing is as much per year as agreed to. Depending on the terms of the contract; the judged riskiness of the bank involved; and related issues, Mike Read says the premium may run from 200% to 400% of the original policy premium.

For extensions of the reporting period beyond what the bank had the contractual right to buy, negotiation is necessary. This additional time is colloquially called "tail coverage." The length of the tail is negotiated and, as part of the negotiations, priced after it is underwritten by the carrier.

So, as an illustration, if a board were covered by a one-year extended reporting period and a three-year tail, board

members would have four years in which to report claims arising during the policy period.

Ideally, "you want to tie the length of coverage to the time period in which a claim may be legally asserted," says Jim McAlpin. He said the price difference between four and six years of reporting ability is minimal, and knowing they'll get such protection appeals to a seller's board members.

"It allows people to sleep better at night," says McAlpin, "because, remember, the entity that would otherwise have indemnified them has gone away."

(Remember, this is all typically with the seller's carrier. Ray Carpenter, of Zurich North America's Financial Institutions D&O section , points out that some institutions that are being acquired have financial problems, for instance; they may have trouble getting an extended reporting period from their current insurer greater than what may be automatically available under their current policy. If the merger agreement calls for an extended reporting period greater than what is automatically available, then the institution and their broker may have to look to the acquiring entity's insurer for the extension or go to the marketplace to find coverage.)

For "continuing characters"

As discussed, the policy that the board-management team relied on under old ownership will most likely stop covering anything new as soon as the bank changes hands. Thus, while the ability to continue reporting issues to the old carrier is important, "acquired" board members and officers must also look forward and be sure they understand the coverage provided by the D&O carrier that the new owners use.

Indeed, Jim McAlpin says it is critical to be sure that the acquiror's coverage automatically extends to the new arrivals.

"It pays to think ahead," says McAlpin. Most good policies will extend automatically to newly "acquired" directors and officers, so long as the target's size doesn't increase the acquirer's size beyond the risk envisioned by the carrier. A concept to look for in the acquiror's policy is "midterm acquisition threshold" and for how it is defined.

Should this become an issue, McAlpin says the new team shouldn't be "naked" of coverage, but they will likely only have 90 days of coverage, typically, in the absence of any new arrangement.

And McAlpin advises boards and officers of the acquiring institutions to review their coverage, as well. As an organization grows through acquisition, it may be outstripping its original D&O policies' protections. A particular risk, especially for publicly held acquirors, is the shareholder suit challenging the wisdom of an acquisition.

And should a board grow in size, it's important to remember that D&O coverage draws on the same bucket for all purposes. It may be time for a bigger bucket.

Getting your act together

The best time to prepare for post-merger D&O protection is before any deal is on the table. Absent a surprise offer, typically a board has reached some consensus about its merger appetite, points out Ray Carpenter of Zurich. One way or another, he adds, most carriers have a good idea of what the bank's plan is. Be clear about what must be done to

ensure protection going forward.

"Directors ‘own' a lot more than ever before," says Zurich's Chris Taylor, so they will want to be sure they are covered. "Their duties and responsibilities have expanded commensurate with recent legislation (Dodd-Frank) so they are more attuned than ever as to the need for broad solutions."

Risks about your risk protection

One word of warning from Bryan Cave's McAlpin. Should the acquirer be a very large bank, it is possible that it will arrange for new coverage of some kind for the directors and officers of the acquired bank through an insurance broker. If that's the case, the proposed coverage must be examined carefully before it is agreed to.

"You don't want to get ‘D&O Lite'," McAlpin says.

And, more generally, McAlpin advises that bankers and board members alike remember that D&O coverage is a negotiable contract, not something out of the box. "There are 70 different D&O insurers," says McAlpin, "and each one has a different form of policy."

"And," he adds, "the best time to negotiate is before the coverage is bound."

Mike Read of the ABA program emphasizes the importance of follow-through. He points out that most carriers require that the extended reporting period and tail coverage must be requested and paid for within 60 days of the effective date of the bank's sale. Thus, if the sale closed in February, the insureds most likely have lost their protection if the carrier hears of no requests until May.

McAlpin also warns seller's board members and officers to be sure they are really going to get the protection being promised. Scrutinize the insurance contracts to be sure they are noncancellable, he advises. Further, he prefers to see coverage paid for in full ahead of the closing of the deal.

Otherwise, McAlpin warns, "there could be an error and you'd be left without coverage."

In April 2011 ABA Banking Journal and Zurich North America presented a one-hour webinar on, "Protecting Your Directors & Officers: Now More Than Ever." To hear the archived webinar, click here .