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State intervention and its effects on executive risk

Why might insurers see rising levels of liability for directors' and officers' of financial institutions in which the state intervened?

Much is being written about the current financial crisis; on its causes, on ways to exit it and on what should be done to avoid its reoccurrence. Meanwhile, banks' management have been steering their institutions through rough waters; some successfully, some not. We have seen governments across the world intervene in troubled banks, adopting strategies ranging from the provision or guaranteeing of additional liquidity, to full nationalisation; trying to bring stability to those banks and the financial systems in which they operate. However, did it also bring stability to the banks' management, reducing their liabilities in the process? The commentary below seeks to explore the effects on management liability and draws a surprising conclusion.

Risk vs. liability

For the purposes of this analysis we would like to draw the distinction between risk and liability. In simple terms risk is the possibility of suffering harm or loss, whereas a liability can be defined as something for which one is liable; an obligation, responsibility, or debt.

Absent a change in existing law, government intervention will not absolve a corporation and its directors and officers from alleged violations of duty or laws. Liability or responsibility for wrongful acts is not removed by state intervention – it is not a 'pardon'. However, would we be correct to suppose that the introduction of such aid may reduce the risk of claims being pursued and/or help mitigate the extent of loss?

Perhaps the most obvious point to note is that state intervention is, by its very nature, a red flag. If the government is intervening, the institution is probably facing significant financial difficulties. This does not necessarily imply wrongdoing by management, but merely that any form of state intervention will lead to the question being asked by stakeholders: how did we get here? Sometimes, due to the size and complexity of the institution concerned, the first step in asking this question may be to directly raise a claim against those supposedly responsible for steering the corporate vehicle into its current troubled position.

In order to assess whether state intervention increases or decreases risk to management, we need to look at some of the different forms of state aid.

Forms of state intervention

As the state can intervene in banks in different ways, our perception of the impact on management risk may be coloured accordingly, being grouped broadly under three categories of intervention measures: (i) guarantee / assets / liquidity; (ii) recapitalisation; and (iii) deposit guarantee.

Guarantee / assets / liquidity

When softer intervention measures are adopted such as government guarantees of bank liabilities (bonds or deposits), impaired asset relief, provision of liquidity facilities or extra financing; in the short-term, it would appear that management risk has been moderated as most stakeholders are likely to adopt a 'wait and see' approach before considering whether to raise a claim. The institution in question should benefit from the 'breathing space' that such measures provide and hopefully the business can be reconstructed in order to remain commercially viable over the long term.

However, there are other factors to consider. How quickly can the business recover? How long will government support be available? What will be the outcome of possible government investigations into the banks' affairs? To what extent will state intervention amend or limit the operations of the bank? Should the bank fail at a later date, what are the implications for management?

One concern must be that claims may be brought at some date in the future (subject to statutory time limits) in relation to acts that take place now or have already taken place. Such claims may be framed with the benefit of hindsight and measured against standards to be introduced as a response to the current crisis.

Recapitalisation

When tougher intervention measures are taken such as effective nationalisation, involving a significant capital injection with government taking control over the bank and replacing the board of directors, the immediate risk to outgoing management is high, as, although it saves them from bankruptcy, it poses a loss of value to shareholders.

Deposit guarantee

In a worst case scenario, state intervention comes only post-failure. Deposit guarantee schemes are common in many countries and are designed to ensure that individuals do not lose the entirety of their life savings in the event of a bank failure. Although they are also used as a preventive measure to avoid a bank run by retail depositors (in fact, several countries boosted the amounts covered by such schemes in the past months), risk to the management comes into play only in case of a bank failure. Where such schemes are called upon, we can see again that immediate risk to management is high.

Insurance protection

In the March 2009 edition of *Financier Worldwide* experts commented that "both the frequency and severity of D&O insurance claims are rising". This trend has continued, notwithstanding various national governments' continuing efforts to address the liquidity vacuum charac- ►►

terising the credit crisis, with lawsuits and market capitalisation losses continuing to mount. The big question to consider for many management teams is: Under what circumstances will directors be indemnified, or incurred claims reimbursed?

Many factors may impact upon the responsiveness of a specific insurance policy to a given set of circumstances. Of key importance is the concept that D&O cover is usually written on a 'claims made' basis. Strictly speaking, such policies only provide cover for claims in relation to acts which occur *and* are notified to the insurer during the policy period. This means that there is a risk of an unknown or unreported claim being made after the policy period and hence not being covered. This position is alleviated by a number of widely utilised devices, but there are issues to be aware of:

First, at renewal time, the insured, is under a duty to disclose any relevant facts which would be material to the insurer's assessment of risk in relation to the insurance policy. When a policy is renewed on the same terms, cover should automatically be given for any acts occurring since the original inception date of the policy. If you move from one insurer to the next or if terms are amended, grey areas or gaps may arise in your cover.

Second, many D&O policies make provision for the notification of circumstances which might lead to a claim in the future. Provided that the circumstances that eventually lead to a claim are properly reported within the policy period, then the claim is deemed to be made.

Third, to continue coverage after the policy period, the policyholder may purchase 'a tail'. Tail coverage (or, the Extended Reporting Endorsement) is an endorsement that extends the claims reporting period after the policy ends.

There are two further specific issues that management will want to consider in the wake of state intervention. First, has there been a change in control of the company by virtue of the state intervention? Most D&O policies include 'Change in Control' provisions which, in the event of a change in management, provide for only those wrongful acts of the corporation and its directors and officers committed prior to the change.

Second, where there has been a change in management teams, what coverage is provided to outgoing directors? Many policies include cover for 'retired directors'; however, in some cases the term is not clearly defined. Does this extend to all previous directors of the company including those who may have been 'fired'? Therefore, should manage-

ment change following a state intervention, it would be preferable to obtain a new policy going forward while tail coverage should be in place for the past.

The issues above are just a few areas we highlight that may be of interest to management. However, state intervention might create significant grey areas in the insurance protection, as numerous other considerations come into play. For this reason it is important to seek the advice and support of a professional insurance broker or other adviser.

Banks therefore face a dual challenge, since rockier times will make it necessary to raise coverage limits for directors in order to retain or procure them. Meanwhile, rising claim notifications mean that insurers will be seeking ways to reduce their exposures to riskier financial institutions: reducing the amount they will underwrite, restricting coverage and increasing premiums.

Conclusion

From a management point of view, therefore, state intervention can be viewed as a double-edged sword. On one hand, soft intervention reduces exposure to shareholders' suits or class actions in the short-term, as opposed to the alternatives of bank failure or nationalisation. On the other hand, if claims are brought at a later date, the passage of time may cause those directors to face an increased risk of loss both in terms of the standards by which they might be judged and the coverage and limits of any insurance policy in effect.

Thus, we can conclude that the overall effects of state intervention, contrary to what one might expect, does not necessarily reduce the liabilities of banks' management but may provoke a false sense of security, in some cases increasing the risk. Good advice to management would therefore be to pay special attention to the insurance coverage they decide to put in place and to carefully select a professional broker and insurer, in terms of their financial strength, knowledge and solutions offered. ■

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