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COMMUNITY BANKING UNIVERSITY
EMERGING LIABILITY RISKS: ARE YOU COVERED?

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Topic Description

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- The risks faced by community banks are evolving.
- From cyber security risks, to new liability theories whipped up by plaintiffs' lawyers, to expanded duties imposed on directors and officers. Insurance policies are also evolving to attempt to address and sometimes exclude these risks from coverage.
- This webinar will discuss how insurance coverage sometimes falls short and what you can do to maximize coverage for these evolving risks.

Overview and Outline of Discussion

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- Common risks that Community Banks face today that are giving rise to insurance issues
- Common insurance coverage issues that Community Banks are facing across multiple lines of coverage, including cyber, general liability, first-party property and D&O
- Common exclusions that insurers are embedding in their policies, and the situations when those exclusions are likely to be implicated
- Practice pointers for ensuring that appropriate coverages are in place and utilized for maximum effect.
- Trends in underwriting and coverage

Coverages Relevant to Community Banks

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- Cyber
- Third-party Liability
- Banking Practices
- Government Investigation
- Employment Liability
- Directors & Officers Liability

Recurring Coverage Issues

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- Duty to defend vs. duty to advance defense costs
- Insured's duty to cooperate
- Considerations for policy renewal
- Gaps in coverage

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Defense:

- The "Duty to Defend" vs. the "Duty to Advance Defense Costs"
  - Many courts hold that [a]n insurer's "obligation to advance defense expenses is not materially different from a duty to defend." *MapleWood Partners, L.P. v. Indian Harbor Ins. Co.,* 295 F.R.D. 550, 601 (S.D. Fla. 2013); *see also Stettin v Nat'l Union Fire Ins. Co. of Pitt., Pa.,* 861 F.3d 1335 (11th Cir 2017).

Recurring Coverage Issues – Cooperation and Association

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Duty to Cooperate/Insurer's Right to Associate: May require disclosure of work product or privileged information to the insurer

- "According to [the common interest rule], communications between an insured and its attorney connected with the defense of underlying litigation are normally not privileged vis-a-vis the insured's carriers in subsequent litigation." *Royal Indem. Co. v. Salomon Smith Barney, Inc.*, 4 Misc. 3d 1006(A), 791 N.Y.S.2d 873 (Sup. Ct. 2004) (collecting cases).
- Jurisdictions are split on whether the cooperation clause requires disclosure of privileged/work-product documents to insurer in coverage dispute
  - *Compare Waste Mgmt., Inc. v. Int'l Surplus Lines Ins. Co.*, 144 Ill. 2d 178, 192-93, 579 N.E.2d 322, 328 (1991) (cooperation clause "renders any expectation of attorney-client privilege…unreasonable" and compelling disclosure of insured's defense counsel's files in coverage action) *with Metro. Life Ins. Co. v. Aetna Cas. & Sur. Co.*, 249 Conn. 36, 59, 730 A.2d 51, 63 (1999) (cooperation clauses did not require disclosure of privileged documents where the insurer had reserved its rights as insurers had failed to fulfill the predicate of associating in the defense as required by the cooperation clauses at issue) and *Remington Arms Co. v. Liberty Mut. Ins. Co.*, 142 F.R.D. 408, 417 (D. Del. 1992) (holding that "the cooperation clause here does not imply a duty to produce documents protected by attorney-client privilege in a coverage dispute").

Risks Facing Community Banks –

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- **Security and Cyber Risks**
  - Data Breach and Loss
    - Recent Equifax breach
      - Affected more than 140 million
      - Illustration of how financial companies handle security risks
      - Broadened the risk profile for many organizations
      - Changed regulatory expectation of cyber risk management
    - Potential harm is wide-ranging:
      - Financial loss to bank
      - Reputational loss
      - Loss of client data and funds
      - Loss of system access
      - Personal exposure of Directors, Officers and Employees

Risks Facing Community Banks –

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- **Security and Cyber Risks, Cont.**
  - No sector is immune, especially financial services
    - E.g., Three top Dutch banks hit in one week (Jan. 2018)
      - ING - distributed denial of service (DDoS) attack
      - ABN Amro - suffered three attacks over a weekend in a total of seven over one week
      - Rabobank - suffered internet banking attack

Risks Facing Community Banks –

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- **Security and Cyber Risks**
  - Social Engineering
    - Techniques
      - Phishing
      - Spear Phishing
      - Whaling
      - Quid Pro Quo
      - Social Engineering
      - Systems Intrusion

Social Engineering – The Long Game

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- Hacking
- Trolling

Impersonation

- CEO
- Customer
- Vendor
- Vendor
- Lawyer

Execution

- Urgent
- Uses email and other mediums
- Uses accurate and/or confidential company and/or employee info

Employee Response

- "I better do this now!"
- "This request is consistent with how we do business."
- "This request is consistent with stuff only a few people in our company know."

Damage

- Lost money
- Lost data
- Malware

Result

- Money unrecovered
- CEO fired
- CFO fired
- Litigation
- Regulatory investigation
- Reputation and Trust Losses

Social Engineering – Example of Execution-Stage Communications

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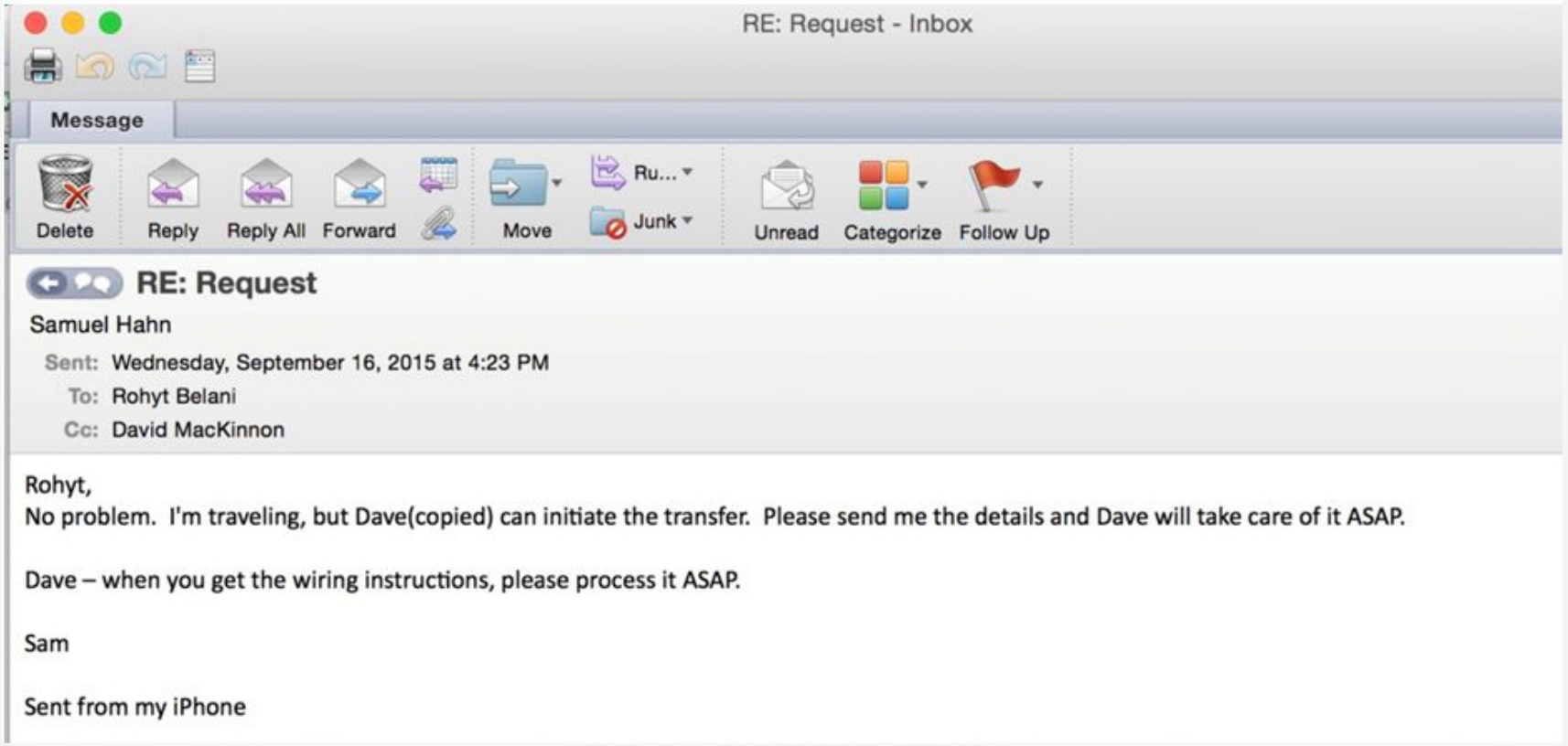

Figure 4 – Our response to the Attacker introducing Dave.

* PhishMe.com

Risks Facing Community Banks – No Industry is Immune*

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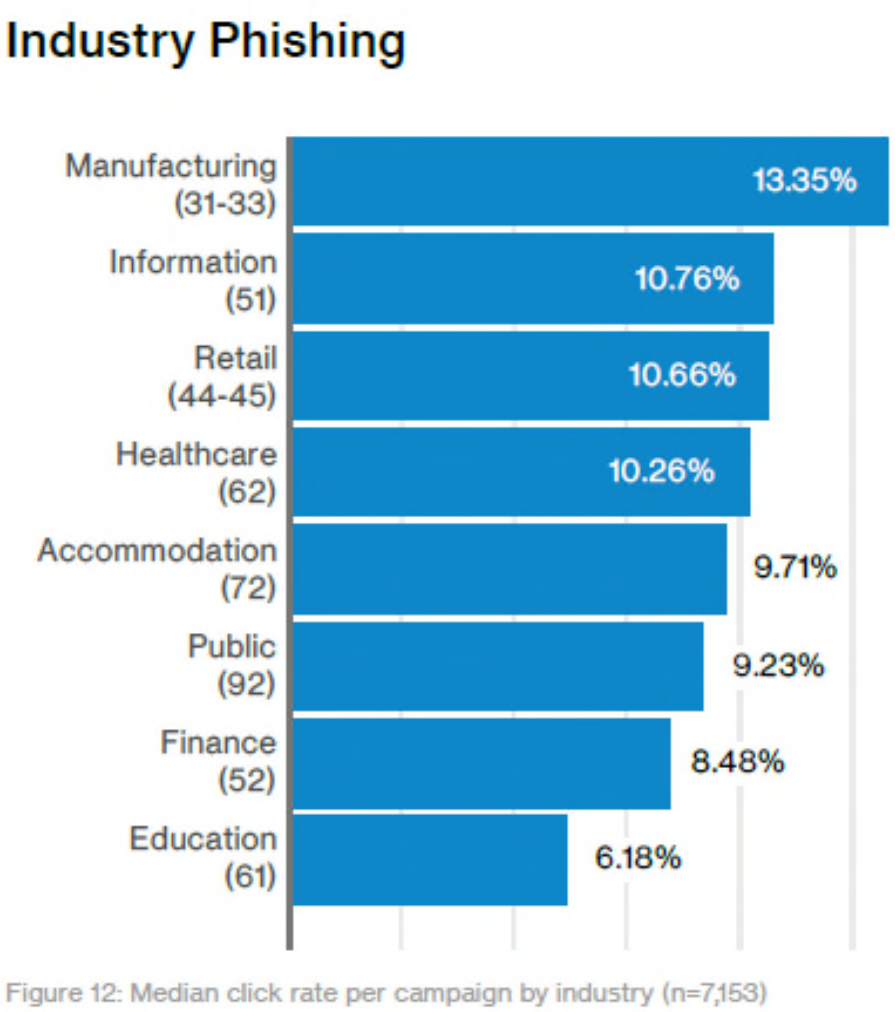

Figure 12: Median click rate per campaign by industry (n=7,153)

$2.3 Billion Lost to CEO Email Scams

Percentage of users who click on phishing links or attachments, by industry.

* Verizon, 2017 Data Breach Investigations Report.

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"Pure" First Party Coverages

Covered Claims

- Data/Information Loss
- Business Interruption
- Network Failure/Interruption
- Cyber-Extortion
- Reputational Harm

Covered Costs

- Forensics
- Legal and PR
- Data Restoration
- Lost Income

Common Endorsements

- PCI-DSS
- Dependent Business Income

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"Hybrid" First Party Coverage – Event Management/Breach Response Costs

Covered Claims/Incidents

- Security Event (e.g., breach, use of code or DDOS against 3rd party)
- Privacy Event (involving PII or Confidential Business Information)

Covered Costs

- Forensics to Determine Existence, Cause & Scope
- Legal and PR
- Mandated – and, sometimes, voluntary – Breach Notification
- Call Centers
- Credit/Identity Monitoring
- Data Restoration

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Third Party Coverages

What Third Parties?

- Customers/clients
- Employees
- Regulators

Covered Liabilities

- Security failures
- Privacy failures
- Professional Services failures
- Media (e.g., online data)

Covered Costs

- Defense Costs
- Judgments & Settlements
- Some types of interest
- Fines?

Not Covered Costs

- Punitive damages

Crime Insurance

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- **Why It Is Critical**
  - Financial loss
- **Common Elements**
  - Covers dishonest third-party acts, e.g.:
    - Employee theft
    - Forgery or alteration
    - Computer fraud and funds transfer fraud
    - Kidnap, ransom, or extortion
    - On- and off-premises robbery, etc.
    - Counterfeit
    - *Sometimes* social engineering/impersonation
- **Endorsement Option**
  - Social Engineering/Impersonation Coverage

Crime Policy Case Law = Mixed Results

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Coverage

Medidata Solutions v. Federal Ins. Co. (SDNY July 21, 2017)

Principal Solutions Group, LLC v. Ironshore Indemnity Inc. (N.D. Ga. Aug. 30, 2016)

No Coverage

Apache v. Great American Ins. Co. (5th Cir. 2016)

American Tooling Center, Inc. v. Travelers Casualty & Surety Company of America (E.D. Mich. Aug. 1, 2017)

Crime Policy Case Law = Mixed Results

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Coverage

***Medidata Solutions v. Federal Ins. Co.*, 2017 WL 3268529 (SDNY July 21, 2017)** – Medidata wired millions of dollars to unknown actor as a result of email "spoofing" scheme. Court held that losses were covered under computer fraud and funds transfer fraud clauses, and rejected insurer's argument that there was no coverage because there was no "entry" or "access" into Medidata's computer system.

***Principal Solutions Group, LLC v. Ironshore Indemnity Inc.*, No. 1:15-cv-4130 (N.D. Ga. Aug. 30, 2016)** –
Court held that insurer must cover $1.717M loss that resulted from wire transfer triggered by fraudulent email.

No Coverage

***Apache v. Great American Ins. Co.*, 662 Fed. App'x 252 (5th Cir. 2016)** – Court held that crime policy did not cover $2.4M loss stemming from payments made based on fraudulent email, finding that loss was not "direct" result of email and instead a result of subsequent failure to investigate.

***Am. Tooling Center, Inc. v. Travelers Cas. & Sur. Co. of Am.*, 2017 WL 3263356 (E.D. Mich. Aug. 1, 2017)** – Court held that crime insurance did not cover losses stemming from fraudulent emails posing as vendor billings; Losses were not "direct" result of fraudulent emails, but instead resulted from intervening negligent actions and authorizations.

Social Engineering Coverage Best Practices

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1. Crime coverage should envision <u>complex</u> schemes.

- Criminals increasingly utilize detailed, confidential information to achieve the scheme.
- The schemes often utilize more than one method of communication (e.g., email, fax, telephone, regular mail).
- The communication methods are impressively authentic.
- Standard crime insurance may not respond to these schemes.
  - What action must precipitate the loss?
  - What happens if there is an intervening communication?
  - How does the form respond to employee negligence?
- Social engineering endorsements may even be insufficient.

Social Engineering Coverage Best Practices

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2. Policy definitions should match technology used by the business.

- E.g.,
  - "Computer system"
  - "Data"
  - Types of "money" (e.g., cryptocurrency)
  - Whose "losses"??

Social Engineering Coverage Best Practices

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3. Exclusions must be carved back to allow the entire scope of intended coverage.

- E.g.,
  - "Authorized" losses
  - "Authorized" employees

Social Engineering Coverage Best Practices

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4. Understand your venue.

- *Taylor & Lieberman v. Fed. Ins. Co.*, 2017 U.S. App. LEXIS 4205 (9th Cir. Mar. 9, 2017) (accounting firm not covered for client losses where coverage was limited to firm's losses only)
- *Pestmaster Services Inc. v. Travelers Cas. and Surety Co. of America,* 2016 WL 4056068 (9th Cir. July 29, 2016) (no coverage for lost funds transferred to a payroll company that failed to remit payroll taxes to IRS)
- *Maxum Indemnity Co. v. Long Beach Escrow Corp.,* No. 2:16-CV-05907 (C.D. Cal. filed Aug. 8, 2016) (under Professional Liability Policy, dispute over coverage for three transfers totaling over $250K)

Social Engineering Coverage Best Practices

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5. Improve your business protocols.

- Multi-factorial verification.
- Require FACE-TO-FACE approval.
- Add approval requirements for “speedy” transfers.
- Do not authorize non-employees (e.g., outside counsel) to direct transfers.

Third Party Risks

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- Any third-party
  - Vendors and subcontractors
  - Clearinghouses
  - Others
  - Payroll processors
  - Others

Third Party Risks - Avoidance

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- Adequate training in how to avoid/recognize potential vulnerabilities is key
  - How much diligence is “due diligence”?
  - How much employee training is required?

Banking Practices and Regulatory Uncertainty

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- Practices under scrutiny in recent years
- Claims implicate coverage under Bankers Professional Liability policies (BPL)
- Typically involve claims for loss resulting from a wrongful act
- While performing professional services.

INSURING CLAUSE

The Company shall pay, on behalf of an Insured, Loss on account of any Claim first made against such Insured during the Policy Period or, if exercised, during the Extended Reporting Period, for a Wrongful Act committed by an Insured or any person for whose acts the Insured is legally liable while performing Professional Services, including failure to perform Professional Services.

Chubb BPL for Financial Institutions 17-02-6683 (Ed. 2/2005)

Banking Practices and Regulatory Uncertainty

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- Overdraft/Fee Litigation
  - May/may not be excluded
    - Policy language is critical
    - Ambiguities should be construed in favor of coverage
      - *But see, BancorpSouth v. Federal*
      - *First Community Bancshares v. St. Paul*
      - *PNC Financial Services v. Houston Cas. Co.*

Banking Practices and Regulatory Uncertainty

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- Lending practices and loan underwriting
  - Critical question – did they give rise to "loss" allegedly caused by a "wrongful act"?
- "Stress" testing
  - Is this a government investigation?
    - If so, see D&O

Banking Practices and Regulatory Uncertainty

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- Regulatory compliance
  - Likewise, may implicate D&O because an alleged board-level failure to meet compliance can give rise to an alleged "Wrongful Act"
  - More on D&O below

Employment Liability

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- Many banks carry Commercial General Liability (***CGL***) insurance as an ordinary staple in their insurance portfolio.
  - But, as broad as such coverage may be, most CGL policies afford only limited coverage for employment-related liabilities.

- To bridge the void, many carry Employment Practices Liability Insurance (***EPLI***).

- Also need to consider Directors and Officers Liability Insurance (***D&O***)
  - which provides coverage to the company, as well as the individual directors and officers, for "Wrongful Acts" by officers, directors, and certain employees.
  - As with other types of insurance, should be routinely reviewed to ensure it meet the needs of the company, its officers and its directors.

D&O Exposures

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- Risks
  - A bank director's responsibilities are similar to directors of other types of corporations, including the duties of loyalty, diligence, and care.
  - Federal banking regulators have strong enforcement powers to address violations of law, breaches of fiduciary duty, or unsafe and unsound practices. Coverage
  - Shareholders and customers can also bring claims alleging breaches of those duties.

D&O Exposures

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- D&O Coverage Basics
  - Protects directors and executives from claims arising out of "Wrongful Acts" in the performance of their corporate duties.
  - Wrongful Acts frequently defined as "any actual or alleged act or omission, error, misstatement, misleading statement, neglect, or breach of duty" of a director or officer in the discharge of his or her duties.

D&O Coverage Agreements

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- Unlike commercial general liability insurance, D&O policies cover financial loss rather than bodily injury or property damage.

Insuring Agreement	Who is Covered
"Side-A"	Insures individual directors and officers of the "Company." Applies where the individual director or officer is not indemnified by the Company.
"Side-B"	Pays for loss incurred by the insured Company in indemnifying individual directors and officers for claims against the directors and officers.
"Side-C"	Entity Coverage. Pays the "Loss" incurred by the Company arising from claims against the Company itself. Usually only covers entity for Security Law violations.

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MusclePharm Corp. v. Liberty Ins. Underwriters, Inc., No. 16-1462 (10th Cir. Oct. 17, 2017)

- 10th Circuit says that the investigation is not a "Claim" under the policy. **No coverage.**
- D&O policy defined "Claim" as "a written demand for monetary or non-monetary relief against an insured person"
- SEC Investigation:
  - May 2013: SEC requests that MusclePharm voluntarily produce documents, noted as "conducting an inquiry"
  - July 2013: SEC issues "Order Direction Private Investigation and Designating Officers to Take Testimony"
    - 21 subpoenas to Ds & Os
  - Feb. 2015: Wells Notices to current and former CFO
  - Sept. 2015: Settlement, cease and desist order
- MusclePharm incurs over $3 million in defense costs

Government Investigations: Is the Investigation a Claim?

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- **Is this a claim?**
  - Is this a formal investigation?
    - Have you received notice that an insured person is the "Target" of an investigation?
    - Have you received written notice that a regulator/government entity intends to pursue charges against an Insured Person or the company?
  - Is this an informal investigation?
    - Have you received an informal request for documents or witness interviews?
    - Have you received a civil investigative demand (CID) or a subpoena for documents?
- Coverage issues:
  - Definition of "claim" is too narrow
  - No defense costs coverage for "informal" investigations

Related Issue: Books and Records Requests (Derivative Investigations)

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- **Historically, coverage under D&O policies was unlikely**
  - No "Wrongful Act"
  - Did not fall within definition of "defense costs" as was not in response to a "claim"
- **How D&O carriers are covering these costs now**
  - Some policies include within definition of derivative investigation costs or separate government investigation endorsement—typically subject to a sublimit
  - Usually only covers individuals but entity may be covered if individual also investigated
  - "Wrongful Act" issue remains

Will Your D&O Coverage Be There When You Need It?

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- Bankruptcy/Insolvency – solutions:
  - Prepaid policy
  - Non-rescindable except for non-payment of premium
  - Insured definition excludes bankruptcy trustee and liquidator
  - Clauses requiring Company and insurer to allow access to funds
  - Side A DIC coverage – additional coverage for individuals
    - "Drops down"
    - Broad form coverage – generally deletes key exclusions
- Policy limits exhausted by payment of defense expenses
  - Solution – higher limits
- Policy limits exhausted by entity coverage
  - Solutions – higher limits; Side A DIC coverage

D&O Cyber Liability

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- Your Ds & Os are not immune from cyber liability
  - Lawsuit or regulatory proceeding alleging wrongful business practice may trigger D&O coverage
    - *See* Verified Shareholder Derivative Compl., *Bennek v. Ackerman, et al. and The Home Depot, Inc.*, Case No. 1.15:cv-02999-TWT (N.D. Ga. Sept. 2, 2015).
  - Make sure there is no gap in coverage or cyber exclusion

Gif from https://media.giphy.com/media/JIX9t2j0ZTN9S/giphy.gif
Originally, www.aaronsanimals.com

D&O Common Exclusions

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- D&O policies typically exclude coverage for claims arising out of intentional or fraudulent acts
  - However, officers and directors accused of negligence in preventing or detecting the fraud may be covered
  - Most policies now require a final adjudication of intent or fraud in order for the exclusion to apply
  - Severability clauses are very important, both for individual insureds and for the entity itself – must address:
    - Misrepresentations on application
    - Imputation of wrongdoing to other directors and officers, or to the entity

D&O Common Exclusions

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- Most policies also have an "insured versus insured" exclusion.
  - Intended to exclude coverage for collusive or friendly suits in which a company may seek to recover ordinary business losses by making claims against the director and officer insureds who were involved in the transaction that gave rise to the losses
  - Need to ensure that definition of "insured" doesn't preclude coverage for derivative claims, bankruptcy trustee claims, and claims by former officers or directors

D&O Common Exclusions – Antitrust Claims

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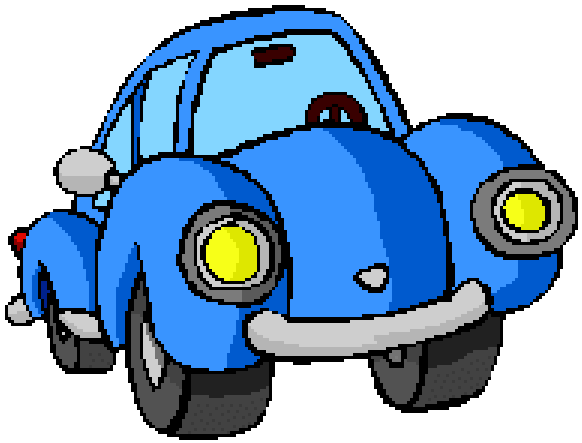
- **Beware of broad antitrust exclusions**
  - No coverage where policy contained a broad exclusion covering claims "alleging, arising out of, based upon or attributable to any…(4) antitrust violations, restraint of trade, unfair competition, or violations of the Sherman Act, Clayton Act or the Robinson-Patman Act, as amended."
    - *Carfax Inc. v. Illinois National Ins. Co.,* Index No. 655198/2016 (N.Y. Sup. Ct. May 16, 2017)



D&O Common Exclusions – Personal Profit & Conduct Exclusions

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- **Personal Profit Exclusion:**
  - Precludes coverage where the Insured gained profit, remuneration or unfair financial advantage to which it was not legally entitled
  - Interpreting these types of provisions, courts typically require the insurer to prove
    - 1) that allegations make out that an insured gained illegal profit or advantage; and
    - 2) that such profit or gain actually occurred. *See e.g,. Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376, 398 (D. Del. 2002).
- **Conduct Exclusion:**
  - Precludes coverage for the insured's dishonest, criminal, or fraudulent conduct
  - Typically requires a "final adjudication"

Intersection of D&O with other Coverages

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- Intersection of D&O, Tech E&O, Cyber Liability, and Crime
  - All are key players to mitigate your risk
  - Beware of gaps between the coverages
  - Don’t assume that your cyber policy covers all potential cyber risks

How Much Coverage Is Enough?

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- Perhaps the most important consideration in evaluating D&O policies is to understand the policy's "eroding" limits
  - D&O policies and many BPL policies provide a single limit of coverage for both defense expenses and indemnification
  - The more officers and directors named in a single case, each of whom is entitled to separate counsel, can quickly eat away at D&O limits, leaving little to cover a settlement or judgment in the case
  - Setting appropriate policy limits ensures that an individual's personal assets are not placed at risk

- Another important consideration in evaluating D&O policies is that they are claims-made policies
  - Claims-made policies typical require insurers to cover claims that are made against the bank during the policy period
  - They also generally require the bank to report the claim to the insurer during the policy period
  - Although extended reporting periods can be negotiated, the courts strictly enforce notice requirements

Top Trends & Tips for Community Banks

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- Lender Liability
- Mortgage Banking Exposures
- Employment Practices Liability
- Cyber and Internet Risks
- General Liability
- Dishonesty and Fraud
- Business Interruption Losses
- Extra Expense Coverage
- Insurance Provided by Third Parties
- Mergers and Acquisitions

Practice Pointers

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- Underwriting –
  - pay attention to your policies on the front end
- Claims and Notice –
  - think broadly and when in doubt, provide notice
- Reps & Warranties –
  - make sure you are doing due diligence when asked to certify no knowledge
- Limits –
  - do you have enough?
- Exposures –
  - do you know your risks and likely exposures?

THANK YOU

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