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U P D A T E

News of Developments in the Financial Sector and Related Areas

* *IN THIS ISSUE* *

Directors and Officers Liability Insurance

Noncumulative Perpetual Preferred Stock

Directors and Officers Liability Insurance

Directors and officers liability insurance coverage ("D&O") is designed to protect the personal assets of directors and officers commonly referred to as insured persons of an institution against *losses* arising from *wrongful acts* and *claims* against them. *Losses* are generally defined in a D&O policy to include defense costs, judgments and settlements which an insured person may incur in serving as a director or officer of an institution. *Wrongful acts* generally include alleged omissions, misleading statements, neglect or breach of fiduciary duties in the discharge of duties as an officer or director of an institution. *Claims* are generally defined to include written demands, civil and criminal proceedings, arbitrations, administrative and regulatory proceedings and investigations.

The preferable coverage for D&O coverage is one where the insurer has the duty to defend the claim. Otherwise the insured is responsible for obtaining its own defense counsel and then having to obtain reimbursement from the insurance company for its costs and expenses.

It is important to determine in connection with indemnification of officers and directors if the institution has adopted indemnification protections in its articles of incorporation, by-laws or other corporate documents whereby the institution will reimburse its directors and officers for expenses or damages incurred for claims brought against them. Otherwise, the director or officer may not be entitled to indemnification once a claim is made against them.

D&O policies are claims made policies which mean that they cover claims made only during the existence of the policy period regardless of whether the alleged wrongdoing occurred during or before the policy. As a result it is important for institutions to maintain D&O coverage after a director's or officer's service ends.

There are three types of D&O coverage available. The first is known as "Side A" which provides coverage on those claims made against individual directors and officers for losses that are not indemnified by the institution. The second is referred to as corporate reimbursement or "Side B" coverage which provides reimbursement for those amounts the institution incurs in its indemnification of claims brought against its directors and officers. The third is referred to as "Side C" which provides coverage when the institution itself is the subject of a claim as in the case of securities violations. Although the forms of coverage will be generally contained in the same insurance policy, each are separate and distinct and may be subject to different deductibles and exclusions.

It is important to understand the difference between derivative actions versus third-party actions. Derivative actions are actions in the name and on behalf of the institution and in the event of recovery, the amount of the recovery goes to the institution. A director's and officer's right to be indemnified in connection with a derivative action is more limited than the right to be indemnified with respect to third-party actions. With respect to third-party actions, the institution may indemnify directors and officers against defense costs, judgments and amounts paid in settlement in those cases where the person acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the institution, and in regard to criminal actions, the director or officer had no reasonable cause to believe that his conduct was unlawful.

Because the institution may not indemnify a director or officer in a derivative action or if the institution is financially unable or has failed, it is important for directors and officers to address the need for Side A coverage. In most instances, there is not a deductible in policies providing Side A coverage. Directors and officers need to be aware of the limits for liability on claims under Side A, Side B and Side C policy coverage.

It is important for institutions to provide indemnification of directors and officers in their governing instruments and to maintain adequate insurance coverage to afford protection from directors and officers having to use their own resources to bear the costs for any claims. D&O policies should be carefully reviewed to ensure that they provide the broadest protection for the personal resources of individual directors and officers. Our firm is available to assist and answer questions involving D&O coverage.

Noncumulative Perpetual Preferred Stock

During the forseeable future, capital may be the biggest issue facing community banks. Noncumulative perpetual preferred stock ("Noncumulative Preferred") is an excellent alternative for bank holding companies that need tier 1 capital. Although common stock should generally be the dominate form of tier 1 capital for a bank holding company, Noncumulative Preferred qualifies as tier 1 capital. The issuance of Noncumulative Preferred also increases the amount of trust preferred securities qualifying as tier 1 capital, in that for each $1 million of Noncumulative Preferred issued, $333,333 of trust preferred securities in tier 2 become eligible for tier 1 capital. Noncumulative Preferred may be issued at both the bank holding company level and the bank level in order to increase tier 1 capital. Because Noncumulative Preferred is considered a separate class of stock, Subchapter S corporations are not eligible since they can only have one class of stock. A coupon payment on Noncumulative Preferred is similar to trust preferred, and the issuer has the option to call the securities after five (5) years. Any redemption of Noncumulative Preferred is subject to regulatory approval. Noncumulative Preferred has no voting rights and is perpetual, meaning that it has no final maturity date. Quarterly dividends are subject to board approval and are noncumulative if not paid. Unlike dividends paid on trust preferred securities, dividends paid on Noncumulative Preferred are not a tax deductible interest expense. Noncumulative Preferred is an excellent vehicle for increasing tier 1 capital, maintaining shareholder ownership, funding acquisitions, stock repurchases and providing funds for internal growth. Our firm is available to answer questions on the benefits of issuing Noncumulative Preferred and the placement of these securities with third parties.

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