Westlaw Journal
INSURANCE COVERAGE
Litigation News and Analysis • Legislation • Regulation • Expert Commentary
VOLUME 25, ISSUE 16 / JANUARY 22, 2015

EXPERT ANALYSIS

The 'Insured vs. Insured' Exclusion — Not as Broad as Insurers Represent

By Darren Teshima, Esq., and Silvia Babikian, Esq.
Orrick, Herrington & Sutcliffe

Recent decisions demonstrate a growing consensus favorable to policyholders on a subject that has divided courts for decades: whether the "insured vs. insured" exclusion in D&O policies prevents coverage for claims brought by a receiver of a failed bank against the bank's directors and officers.

In the wake of the financial crisis, the Federal Deposit Insurance Corp. brought numerous actions against former directors and officers, alleging negligence and mismanagement. When directors and officers tendered the claims to their D&O insurers, the insurers often denied coverage, citing the insured-vs.-insured exclusion and arguing that the FDIC stepped into the shoes of the failed bank, another insured.

Thankfully for policyholders, the majority of courts that have addressed this issue have rejected the insurers' argument. The recent decision in *St. Paul Mercury Insurance Co. v. Hahn,* No. 13-0424, 2014 WL 5369400 (C.D. Cal. Oct. 8, 2014), highlights this growing trend.

On Oct. 8 the U.S. District Court for the Central District of California rejected an insurer's reliance on the insured-vs.-insured exclusion. In that case, the FDIC stepped in as receiver for a failed bank, Pacific Coast National Bank.

The FDIC brought a lawsuit against six of Pacific Coast's directors and officers, alleging that they failed to properly discharge their duties and obligations in managing the bank. The FDIC said the directors and officers improperly originated and approved loans in violation of Pacific Coast's own policies, extended credit to unqualified borrowers, approved and originated speculative commercial real estate loans, and committed a series of other misdeeds.

The directors and officers tendered the claim to Pacific Coast's D&O insurer, Travelers. Travelers (through St. Paul Mercury Insurance Co.) sought a declaratory judgment that the D&O policy did not cover the claims against the directors and officers. Travelers argued that the insured-vs.-insured exclusion barred coverage because the FDIC was acting "on behalf" of Pacific Coast. On cross-motions for summary judgment, the court ruled for the policyholders and held that the exclusion did not bar coverage.

While the *Hahn* decision is consistent with the majority of courts that have addressed the issue, the jurisprudence about the scope of the insured-vs.-insured exclusion is far from settled. Indeed, there are decisions coming out on both sides of the issue dating back to the 1980s, when insurers relied on this exclusion to deny similar claims related to the savings and loan crisis.

THE INSURED-VS.-INSURED EXCLUSION

The insured-vs.-insured exclusion in insurance policies excludes from coverage claims based on suits brought by one insured against another. The exclusion generally reads as follows, as it did in the policy at issue in *Hahn*:

> The insurer shall not be liable for loss [including defense costs] on account of any claim made against any insured … brought or maintained by or on behalf of an insured or company [including the bank] in any capacity, except a claim that is a derivative action brought or maintained on behalf of the company by one or more persons who are not directors or officers and who bring and maintain such claim without the solicitation, assistance or active participation of any director or officer.

Insurers added the exclusion to their D&O policies in the mid-to-late 1980s when financial institutions allegedly "collusively" sued their own directors and officers in an attempt to recover losses with proceeds from their D&O policies. A classic example of such a supposed collusive suit was when Bank of America sued six of its officers for millions of dollars in damages in 1985. *Bank of Am. v. Powers,* No. C536-776*, complaint filed (*Cal. Super. Ct. Mar. 1, 1985*)*.

Bank of America blamed its officers and directors for their allegedly bad decisions related to their mortgage-backed securities practice, and it sought D&O coverage for the claims. Although the case ultimately settled, the insurer argued that the D&O policy did not provide coverage. This was because Bank of America had brought its claims in an effort to negate its capital losses by suing its own directors and officers in order to gain access to their insurance coverage.

Since that time, insurers have regularly cited the exclusion in an effort to avoid covering claims brought by the FDIC after a bank failure. Under the Financial Institutions Reform, Recovery and Enforcement Act of 1989, or FIRREA, the FDIC has broad authority to operate failed banks and dispose of their assets once it is appointed as a receiver.

Directors and officers say a lawsuit brought by a receiver is not the sort of "collusive" lawsuit that the insured-vs.-insured exclusion seeks to avoid.

In its capacity as receiver, the FDIC will often sue the bank's directors and officers. The directors and officers, in turn, assert that the claims against them are covered by the bank's D&O policies, as the directors and officers did in *Hahn*. Insurers regularly deny coverage for these claims, arguing that if the bank could not have sued its directors and officers, then a receiver acting in the bank's stead and suing on behalf of the bank, likewise, cannot bring the suit.

On the other hand, directors and officers contend that a lawsuit brought by a receiver is not the sort of "collusive" lawsuit that the insured-vs.-insured exclusion seeks to avoid. They assert that the FDIC is genuinely adverse to the defendant officers and directors. Although courts around the country have not adopted a uniform jurisprudence regarding these cases, they regularly hold that directors and officers are entitled to coverage when the FDIC sues them.

MOST COURTS FIND EXCLUSION DOESN'T APPLY TO RECEIVERS' CLAIMS

The *Hahn* court's decision granting coverage under the D&O policy follows the majority rule and the recent trend of courts holding that the exclusion does not preclude coverage for receivers' claims. When the FDIC stepped in as a failed bank's receiver, the insurer, Travelers, argued that the claims made by the FDIC against the directors and officers belonged only to Pacific Coast, which was also an insured under the policy.

Relying on the insured-vs.-insured exclusion, which excluded coverage for claims brought "by or on behalf of an insured or company," Travelers said the FDIC was bringing those claims "on behalf of" Pacific Coast in a receivership capacity. Since the insured-vs.-insured exclusion would apply if Pacific Coast brought the action, St. Paul contended, the claim could not be covered simply because the FDIC brought the claim on Pacific Coast's behalf.

The FDIC said because the policy defined the "insured" to be Pacific Coast, the FDIC's action against the directors and officers could not be brought by Pacific Coast and was not on its behalf. The FDIC further said that nobody from the bank had any involvement in bringing the claim. Additionally, as the party drafting the policy, Travelers could have included a provision explicitly excluding coverage for a suit brought by federal regulators, receivers generally or the FDIC specifically, but it did not.

Furthermore, the FDIC argued that the shareholder exception to the insured-vs.-insured exclusion provided coverage because it specifically allowed derivative claims by shareholders on behalf of the bank. Travelers disagreed, saying the FDIC action was not technically a derivative action. The court favored FDIC's position, noting that the FDIC can act in a variety of capacities, and that the shareholder exception "evidences an intent to place on [the] insurer the risk for actions against the D&Os."[1]

The *Hahn* court agreed with the FDIC and the directors and officers, holding that the exclusion was ambiguous as to the FDIC, particularly because courts across the country have reached conflicting interpretations of the exclusion. The court said the unsettled case law put insurers on notice that the exclusion was ambiguous, and that to be effective in this circumstance, the exclusion should be more clearly explained.

The court also said Travelers could have included an exclusion to bar claims asserted by the FDIC, as the insurer offered an optional regulatory exclusion explicitly naming the FDIC. Since California law, like the law of most states, requires ambiguities in an insurance policy to be resolved against the insurer, the court held that the insured-vs.-insured exclusion did not apply.

Other courts, such as a the federal court in Puerto Rico in *W Holding Co. Inc. v. AIG Insurance Co.*, have similarly recognized that a receiver does not merely "stand in the shoes" of a failed institution, but can also bring claims on behalf of the institution's shareholders and creditors.[2] These holdings comport with statutory law as well, which recognizes the FDIC's capacity to bring derivative claims.

Under FIRREA, the FDIC has the authority to succeed not only to the rights of the failed bank, but also to those "of any stockholder, member, [or] accountholder … of such institution."[3] Therefore, "the FDIC differs from other receivers insofar as it is given the exclusive authority to bring claims to recover losses by shareholders."[4]

Since California law, like the law of most states, requires ambiguities in an insurance policy to be resolved against the insurer, the court held that the insured-vs.-insured exclusion did not apply.

THE CASE LAW IS UNSETTLED

Despite decisions like *Hahn* and *W Holding*, application of the insured-vs.-insured exclusion to FDIC claims remains unsettled. As the 1st U.S. Circuit Court of Appeals put it in *W Holding*, "[w] hat we have is a classic battle of dueling case law."[5]

Courts that have applied the insured-vs.-insured exclusion to claims brought by the FDIC have pointed to insurers' fears of collusion — the reason insurers included the exclusions in the first place.[6] For example, in *St. Paul Mercury Insurance Co. v. Miller*, 968 F. Supp. 2d 1236, 1243 (N.D. Ga. 2013), the FDIC took over for a failed bank as receiver and then sued two bank employees for improper and negligent activities. The individuals sought coverage under the bank's D&O policy, issued by St. Paul.

St. Paul agreed to cover defense costs under a reservation of rights and initiated a lawsuit to establish no coverage based in part on the insured-vs.-insured exclusion. The exclusion provided that the insurer was not liable for any claim "brought or maintained by or on behalf of any insured or company in any capacity," although certain exceptions applied.

The FDIC argued that because the purpose of the insured-vs.-insured exclusion is to prevent collusive suits, the exclusion is inapplicable to the FDIC, which, it asserted, was clearly not collusive. The court disagreed with the FDIC and said it could not refuse to give effect to an "unambiguous term of the policy based on an assumption of why the language was put into the policy."[7] The court agreed with the insurer, holding that because the FDIC stood in the failed bank's shoes, the insured-vs.-insured exclusion precluded coverage.

The 11th Circuit reversed the *Miller* decision Dec. 17.[8] Like the court in *Hahn*, the 11th Circuit correctly found that the insured-vs.-insured exclusion was ambiguous in light of the numerous conflicting decisions addressing the issue.[9] The appeals court remanded the case to the District Court, directing the parties to provide extrinsic evidence to determine their intent when they entered into the policy.

HOW POLICYHOLDERS CAN PROTECT THEMSELVES

While some decisions have supported prohibiting coverage because of the insured-vs.-insured exclusion, they are outnumbered by decisions like *Hahn*, which signal a growing consensus that the exclusion should not apply to suits brought by the FDIC and other regulators. *Hahn* correctly recognizes that the FDIC acts in multiple capacities and "on behalf of" a variety of interests in addition to the failed bank. The insured-vs.-insured exclusion, therefore, should not be read to exclude coverage for claims by a receiver.

Policyholder financial institutions that are concerned about whether D&O coverage will be available in the unfortunate event of a receiver taking over should consider obtaining policy language that specifically carves out such claims from the insured-vs.-insured exclusion. For example, a recent policy includes an exclusion with the following exception:

> This policy shall not cover any loss in connection with any claim brought by or on behalf of an insured, provided however, that *this exclusion shall not apply* to any claim brought or maintained by or on behalf of a bankruptcy or insolvency trustee, examiner, *receiver* or similar official for the company or any assignee of such trustee, examiner, receiver or similar official.

Such policy language will better serve policyholders in challenging an insurer's denial of such a claim.

Despite decisions like Hahn *and* W Holding*, application of the insured-vs.-insured exclusion to FDIC claims remains unsettled.*

NOTES

[1] *St. Paul Mercury Ins. Co. v. Hahn*, No. CV 13-0424), 2014 WL 5369400, at *5 (C.D. Cal. Oct. 8, 2014); *see also FDIC v. BancInsure*, No. CV 12-09882 (C.D. Cal. June 16, 2014).

[2] *See W Holding Co. v. AIG Ins. Co.*, No. 11-2271, 2014 WL 3378671, at *1-2 (D.P.R. July 9, 2014) (granting summary judgment to the policyholders and rejecting the insurer's argument that the insured-vs.-insured exclusion prevented coverage for the FDIC's claims against the directors and officers because they were made "on behalf of" or "in the right of" the failed bank); *see also Fid. and Deposit Co. of Md. v. Zandstra*, 756 F. Supp. 429, 433 (N.D. Cal. 1990); *American Cas. Co. v. FDIC*, 713 F. Supp. 311 (N.D. Iowa 1988).

[3] 12 U.S.C. § 1821(d)(2)(A)(i).

[4] *BancInsure*, No. 12-09882 (C.D. Cal. June 16, 2014).

[5] *W Holding Co. v. AIG Ins. Co.*, 748 F.3d 377, at 386 (1st Cir. 2014).

[6] *See, e.g.*, *Hyde v. Fid.and Deposit Co. of Md.*, 23 F. Supp. 2d 630, 634 (D. Md. 1998) ("Because these claims would not be covered under the policy if asserted by the bank, it is difficult to argue that they should be covered when asserted on behalf of the bank by its receiver. To find otherwise would be an affront to the purpose of the insured-versus-insured exclusion." (internal quotation omitted)).

[7] *Miller*, 968 F. Supp. 2d at 1243.

[8] *St. Paul Mercury Ins. Co. v. FDIC*, No. 13-14228, 2014 WL 7172472 (11th Cir. Dec. 17, 2014).

[9] *Id.* at *7 ("The FDIC-R asserts a number of arguments in support of its contention that the insured-v.-insured exclusion is unambiguous and should not apply. However, it seems to us that the most compelling argument is that courts who have addressed similarly worded insured v. insured exclusions have reached different results.").


Darren Teshima (L) is a partner in **Orrick, Herrington & Sutcliffe**'s insurance recovery group, based in San Francisco. His commercial litigation practice concentrates on the representation of corporate policyholders in insurance coverage disputes. **Silvia Babikian**, (R) an associate in Orrick's insurance recovery group, is based in New York. She represents large companies in various commercial and insurance-related matters.