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Policyholder Alert

"History never repeats itself, but it does often rhyme"

— D&O Policies Continue to Cover Liabilities Arising from Bank Failures

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Key points:

In the current banking crisis as in past crises, D&O insurance should respond to claims facing directors and officers from receivers and other claimants.

History suggests that some insurance companies will invoke the "insured v. insured" exclusion to bar coverage.

Most courts, including U.S. Courts of Appeal, have rejected the insured v. insured defense against coverage for claims involving the FDIC.

For nearly a century, as bank failures have come in cycles, D&O insurance claims from the directors and officers as well as from the banks' receivers have followed close behind. Corporations began to purchase directors' and officers' (D&O) liability insurance policies starting in the late 1930s on account of liabilities created by securities regulations enacted in response to the Great Depression. D&O liability insurance protects directors and officers from liability and permits institutions to attract and retain qualified executives. Through several sets of bank failures — the savings and loan crisis of the 1980s and 90s, during which almost one-third of savings and loans failed; the dot-com crisis of the early 2000s; and the financial crisis of 2008 during which over 460 FDIC-insured banks failed — D&O insurance has been available to protect bank D&O's and to compensate for loss.

Here we are again. In March 2023, within the space of two weeks, a major crypto lender failed, two FDIC insured banks were closed, a major European bank tapped a $50 billion-plus lifeline, and the parent company of a U.S. FIDC insured institution filed for Chapter 11 bankruptcy.

In the prior crises, the FDIC regularly asserted claims in its capacity as a receiver of failed banks, as did directors and officers whom plaintiffs (including the FDIC) have sought to hold liable for their losses. While insurance companies have sometimes asserted defenses against covering these claims, courts have more often than not found that coverage exists.

The so-called 'insured v. insured' exclusion is perhaps the most frequently invoked defense against D&O coverage for FDIC claims related to bank failures. This exclusion purports to preclude D&O coverage for claims by an insured corporation against its directors and officers. This exclusion originated in the

early 1980's in response to attempts by several corporations to obtain D&O coverage for losses resulting from the acts of officers and directors. Thus, the exclusion was widely thought to prevent only collusive lawsuits by a corporation against its officials.

Some insurance companies argued in earlier banking crises that the exclusion precludes coverage when a statutory receiver, such as the FDIC, sues a former director or officer. However, most courts held that the exclusion does not apply in these situations on grounds that the FDIC, as a statutory receiver, is a sufficiently adverse party to the failed financial institution, not an "insured." Thus, lawsuits brought by the FDIC against directors and officers of a failed financial institution cannot be collusive in nature. In the wake of the 2009 crisis, two United States Courts of Appeal reached similar results in two disputes between the FDIC and one insurance company. *See, e.g.*, *St. Paul Mercury Ins. Co. v. FDIC*, 669 Fed. App'x 851 (9th Cir. 2016); *St. Paul Mercury Ins. Co. v. FDIC et al.*, 774 F.3d 702 (11th Cir. 2014). These disputes involved different bank failures but the same policy language.

The boilerplate language contained D&O policies and in the insured v. insured exclusion often uses the terms 'by' or 'on behalf' — for example, in the policy cited by the Eleventh Circuit in *St. Paul*, barring coverage for an Insured for any claim "brought or maintained by or on behalf of any [other] Insured." From those terms, insurance companies will argue that the receiver, standing in the shoes of the failed bank, is bringing a claim 'by' or 'on behalf' of the insured. However, many courts have sided with policyholders, reasoning, as did the Ninth Circuit in *St. Paul*, that "it is ambiguous whether the FDIC as receiver is pursuing its claims against the directors and officers 'on behalf of' the defunct bank within the meaning of the "insured v. insured" exclusion, because the FDIC as receiver represents a number of interests and does not operate as a normal successor in interest." While St. Paul Mercury, in the 2014 case, cited a Supreme Court decision *(O'Melveny & Myers v. FDIC*, 512 U.S. 79, 1994) that found, in a different context, that the FDIC "steps into the shoes" of a failed financial institution, the Eleventh Circuit held that with respect to the insured v. insured provisions,

> the legal significance of this statement is limited because as the Bank's receiver, FDIC-R steps into a number of pairs of different shoes—as it were the wingtips of the Bank, the pumps of any stockholder, the loafers of any accountholder, and the tennis shoes of any Bank depositor—because the FDIC sues to recoup not only its own losses, but also the losses of depositors and other creditors.

The rules of insurance policy construction require, and courts demand, that exclusions be drafted in clear and unmistakable language. Insurance companies instead draft forms susceptible of multiple reasonable interpretations. Thus, the ambiguity in the 'insured v. insured exclusion' continues to persist in the context of failed bank claims. Both the Eleventh Circuit and the Ninth Circuit deemed the insured v. insured exclusion ambiguous with respect to the FDIC, noting that lower courts had split over its applicability.

In the wake of a bank failure, D&O insurance companies may throw up a number of roadblocks to insurance recovery. The insured v. insured exclusion is but one example. Crises imposing loss

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and liabilities often lead to insurance disputes — so commonly that one might say that the cycles of loss and dispute follow Mark Twain's dictate and 'rhyme.' Policyholders can resist improper insurance company attempts to limit insurance coverage by knowing not only their policy language, but the case history of disputes involving that language. While D&O insurance policies can be one the most important assets for a failed bank and its D&Os, maximizing that asset often requires persistence and creativity in dispute resolution.

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