Whither the FDIC

It Might Become the 800-Pound Gorilla of Corporate Insurance Recovery

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The Federal Deposit Insurance Corporation (FDIC) will have its hands full for years to come in dealing with the aftermath of the implosion of the global banking system and the decimation of the U.S. housing market. The fallout for financial institutions in particular has been devastating, with a number of banks, both big and small, collapsing or otherwise on the brink. By November 13, 2009, 123 banks had failed since the beginning of the year — four times as many as in 2008. For the quarter that ended September 30, 6.25 percent of U.S. mortgages were at least 60 days past due, an all-time high.

In stark contrast, in 2005 and 2006, there were no FDIC-insured bank failures. In 2007 there were three. In 2008 there were 25. In 2009, there were 140. A number of factors are driving the spike in bank failures, including bad management, bad risk controls, record loan delinquencies, and both internal and external theft. Insurance policies that address these perils include directors, and officers, (D&O) insurance policies, fidelity/financial institution bonds, commercial crime insurance policies and mortgage default insurance.

The FDIC functions in two capacities: 1) its corporate capacity, under which it insures the deposits of its 8,305 member banks and regulates their financial condition; and 2) its capacity as a receiver or conservator for failed and failing banks. The higher rate of bank failures is increasing strain on the FDIC's resources in both of its capacities, and putting added pressure on the agency to recover losses from insurers and insured third parties. The agency's insurance-fund balance dropped by almost half in the fourth quarter of 2008, from $35 billion to $19 billion. To keep funds from dwindling, the FDIC raised deposit-insurance assessment rates in the second quarter of 2009, adding to the burden that already troubled banks will have to bear.

Never has the FDIC been more motivated to be aggressive about insurance recoveries.

The FDIC is well versed in insurance coverage battles with the insurance industry, having fought numerous and heavily litigated contests in the wake of the S&L crisis over D&O insurance coverage and financial institution bond coverage. In the current crisis the FDIC is again pursuing insurance assets of failed banks, such as mortgage insurance policies that were purchased to protect the bank against the risk of default by borrowers under various types of mortgage products. There are already reports of disputes over mortgage insurance coverage where insurance companies are refusing to honor their coverage obligations.

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As such, the FDIC is poised once again to be at the forefront of protecting depositors and others by marshalling, among other things, insurance assets to defray the costs of bank failures to the American taxpayer.

Did an Insurance Coverage Denial Help Precipitate the Failure?

Given the sheer number of bank failures (with more to come), the FDIC will have its hands full with insurance claims. A threshold question to always ask (and answer) is, how did the bank become insolvent? If it turns out that an insurance company's misconduct in handling an insurance claim imperiled the bank's financial condition, then the insurance company may be liable for consequential and exemplary damages. By way of example, if a mortgage insurance company refuses to provide coverage for mortgage loan defaults (especially in this environment with record numbers for delinquencies) and this causes the bank to become insolvent, then the insurance company can be liable for consequential damages in addition to the amount of the coverage owed to the policyholder all along.

In a landmark case decided recently, *Bi-Economy Market, Inc. v. Harleysville Insurance Company of New York, et al.*, 10 N.Y. 3d 187 (2008), New York's highest court ruled that where an insurance company wrongly denies coverage and causes the demise of its policyholder's business, it is responsible for consequential damages. In the New York case, the policyholder had suffered a covered loss. Rather than provide coverage in full, the insurance company disputed its obligations and paid only a fraction of the policyholder's property claim and a bit more than half of the policyholder's business income claim. The court held that the policyholder's "claim for consequential damages including the demise of its business, were reasonably foreseeable and contemplated by the parties[.]" *Id.* at 196. The court also found that the insurance policy required the insurance company to "evaluate a claim, and to do so honestly, adequately, and — most importantly promptly." *Id.* at 195.

Other jurisdictions have long held that an insurance company that wrongfully denies coverage can be liable for consequential losses, bad faith, exemplary damages and attorney fees. The bottom line for the FDIC and others representing policyholder interests under such circumstances is that it is critically important to evaluate and pursue bad faith and consequential damages claims against insurance companies which have improperly refused to provide coverage for covered claims.

FDIC/RTC/FSLIC Suits vs. Former Management

The FDIC is also likely to see a repeat of coverage defenses it has previously had to litigate with the insurance industry. Many D&O insurance companies have tried to void coverage by arguing that claims made by the FDIC, FSLIC and the RTC trigger the so-called "insured vs. insured" exclusion found in the majority of D&O policies. Some insurance companies have also relied upon so-called "regulatory agency" exclusions in an attempt to escape their insurance coverage obligations. Many courts have rejected

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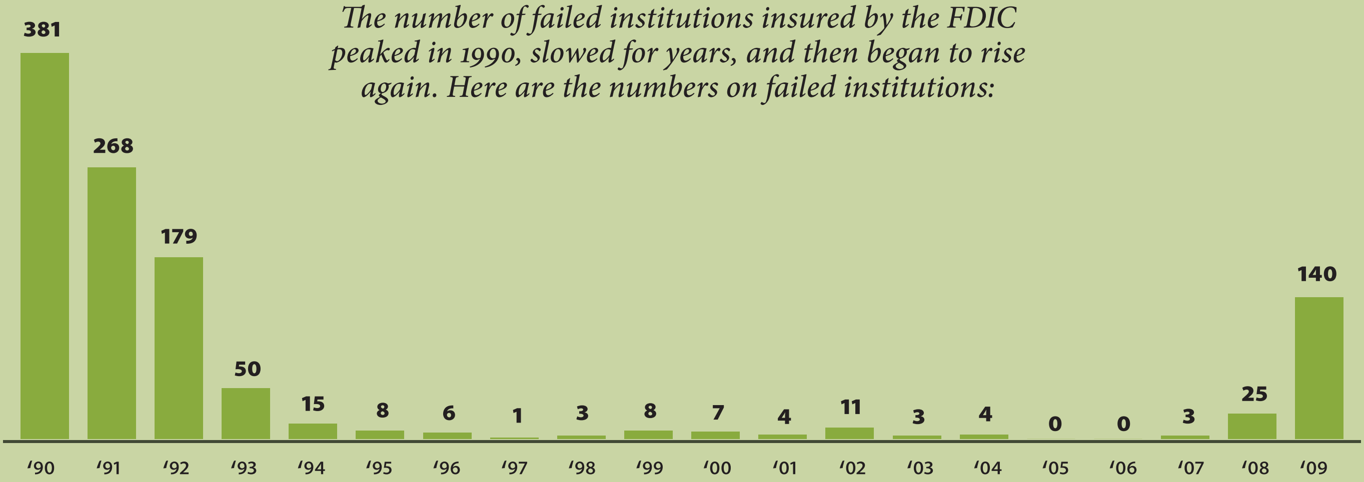
The Ups and Downs of Bank Failures

The number of failed institutions insured by the FDIC peaked in 1990, slowed for years, and then began to rise again. Here are the numbers on failed institutions:



Source: *FDIC*

> *"It is worth remembering that as long as the suit by the receiver or administrator is not collusive in nature, then the insured vs. the insured exclusion should never cause a forfeiture of insurance coverage."*

these arguments on the basis of the policy terms, the intentions of the parties and public policy grounds. Nevertheless, because there is neither uniformity throughout the various legal jurisdictions nor within the terms of the various forms of D&O insurance coverage on these exclusions, the FDIC can count on having to litigate many of these same issues.

It is worth remembering that as long as the suit by the receiver or administrator is not collusive in nature, then the insured vs. insured exclusion should never cause a forfeiture of insurance coverage. Is very hard to imagine an instance in which a suit commenced by the FDIC would ever be collusive in nature. Some of the more recent forms of D&O insurance seem to recognize this fact, and seek to clarify this point by specifically excepting from the exclusion claims brought by any examiner, trustee, receiver, liquidator or rehabilitator.

Despite this, the FDIC and attorneys representing its interests should be aware of the background and purpose for the insured vs. insured exclusion to combat improper insurance company attempts to apply the exclusion beyond its intended scope.

Conclusion

Given the staggering number of bank failures to date, the FDIC can safely count on having to battle the insurance industry under at least three insurance products: D&O insurance, fidelity insurance, and mortgage insurance. Securing this insurance coverage will be critical to ameliorating the impact of the huge spike in bank failures. Given the sheer scope of the banking crisis, as well as the record number of failures, the FDIC — whose mandate is to mitigate losses from bank failures wherever possible — can be expected to pursue insurance recoveries on a scale not seen since the 1980s. And given the insurance industry's predictable desire to avoid having this exposure shifted to its shoulders, we can expect to see the gloves come off. ▲