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The Flaws In Ga.'s Insured V. Insured Exclusion Ruling

Law360, New York (September 30, 2013, 12:40 PM ET) -- In a recent decision for insured directors and officers of banks and other companies under their directors and officers insurance policies, the United States District Court for the Northern District of Georgia held that the “insured v. insured” exclusion of a failed bank’s D&O policy barred coverage for the bank’s officers in an action brought by the Federal Deposit Insurance Corporation (FDIC) in its capacity as the bank’s receiver.

The result in St. Paul Mercury Insurance Co. v. Miller, et al., 2:12-CV-0225-RWS (Aug. 19, 2013), is a noteworthy departure from a number of other decisions ruling that claims brought by the FDIC as receiver do not trigger such exclusions and thus do not preclude bank officers and directors from obtaining the benefit of D&O coverage in defending and settling such claims.

Insured v. insured exclusions are common provisions in D&O policies that exclude coverage for some claims made against an insured person or entity by another insured under the same policy. The St. Paul Mercury case arose from the failure of the Community Bank & Trust (CB&T) in Georgia.

Following its appointment as receiver, the FDIC brought suit against two CB&T officers for their alleged roles in improperly approving unrecovered loans that led to the bank’s failure. The insurer denied the officers’ claims for D&O coverage, contending that the FDIC’s claims as receiver were made “on behalf of” the insured bank and that coverage was therefore barred by the insured v. insured exclusion in the CB&T policy.

The court agreed. It relied heavily on the U.S. Supreme Court’s decision in O'Melveny & Myers v. FDIC, 512 U.S. 79, 86 (1994), which held that the FDIC “steps into the shoes” of a failed bank when it acts as receiver, and therefore, claims asserted by FDIC in that capacity are subject to the same defenses that could have been raised against the bank itself.

Moreover, the court declined to follow other case law holding that insured v. insured exclusions did not bar coverage of claims by the FDIC as receiver, on the grounds that the policies in those cases did not contain language excluding coverage for any claims brought “by or on behalf of any [insured] in any capacity.”

The court further held that this language must be enforced regardless of whether it actually advanced the exclusion’s general purpose of preventing collusive lawsuits between co-insureds.

The district court’s reasoning in St. Paul Mercury is seriously flawed. First, the O'Melveny decision on which it relied did not involve an insurance claim but rather focused on the validity of alleged legal defenses to direct civil damages claims asserted by the FDIC against third parties.

Despite the court's insistence that "there is no rule that the [FDIC] should always win," the real issue here was whether the insurer owed defense and indemnity coverage to the bank's officers — not the FDIC — under their employer's D&O policy. Because the insurer's defense was raised against a coverage claim by those officers, the O'Melveny decision is inapposite.

Second, the court found that the FDIC's action against the officers was brought "on behalf of" the insured bank (i.e., CB&T), even though numerous courts have recognized that the FDIC may act in a variety of capacities, including on behalf of a failed bank's depositors.

Indeed, the court did not address or even acknowledge a strikingly similar case earlier this year by another judge in the same district court, which ruled that it was "unclear" whether claims by the FDIC as receiver are brought "'by' or 'on behalf of' the failed bank." Progressive Cas. Ins. Co. v. FDIC, 1:12-CV-1103-RLV, slip op. at 5 (N.D. Ga. Jan. 4, 2013). Accordingly, the insurer's attempt to escape coverage on summary judgment in that case was denied.

The district court in Progressive recognized that the FDIC's role "differs from other receivers or conservators that might step into the shoes of a failed or insolvent bank" and is tasked as receiver "with bringing claims to recover losses suffered by the federal Deposit Insurance Fund and a bank's depositors, creditors, and shareholders." Id.

Other district courts that have grappled with the insured v. insured exclusion in the context of FDIC suits have also recognized the FDIC's multiple roles. American Cas. Co. of Reading, Pa. v. Baker, 758 F.Supp 1340, 1348-50 (C.D. Cal. 1991) (FDIC acts "not only as [a] successor, but as a creditor itself, on behalf of the creditors and shareholders of the institution, and as subrogee to the rights of depositors"); FDIC v. Zaborac, 773 F. Supp. 137, 142-44 (C.D. Ill. 1991) (similar).

Rather than construe the policy at issue broadly in favor of coverage, as the law requires, the St. Paul Mercury decision denies the officers any D&O protection while also reducing the total pool of funds potentially recoverable by the FDIC for the failed bank's depositors.

Also, in summarily distinguishing bankruptcy trustee actions, the decision overlooks the similar roles played by the FDIC and bankruptcy trustees. Both are independent fiduciaries charged with representing the interests of creditors and other stakeholders and bring claims against directors and officers "on behalf of" those other constituencies. While the case law is not unanimous, most bankruptcy courts have declined to apply insured v. insured exclusions to bar D&O coverage in that context.

Nonetheless, insurers are likely to rely on the St. Paul Mercury decision in future cases involving the application of the insured v. insured exclusion to D&O coverage of claims brought by the FDIC as receiver, as well as claims by bankruptcy trustees. Responding policyholders should be prepared to point out the defects in that decision and to harness the sounder reasoning expressed in cases acknowledging the specialized role of the FDIC.

D&O policyholders should also take note that the St. Paul Mercury trap can be avoided altogether by demanding an express carve-out from the insured v. insured exclusion in their policies providing that the exclusion will not apply to claims brought by a bankruptcy trustee, receiver, conservator or other similar type of official.

Insurers commonly agree to incorporate such exceptions because they do not interfere with the exclusion's primary aim of discouraging collusive lawsuits. Indeed, most public company D&O policies already contain such carve-outs.

St. Paul Mercury will be easily distinguished where such a carve-out is present, although care must be taken that the specific wording of the carve-out is sufficiently broad. All D&O policyholders are well advised to consult knowledgeable coverage counsel at purchase and renewal to ensure that they steer clear of such readily avoidable traps for the unwary.

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