

Client Alert

Latham & Watkins
Litigation Department

D&O Liability Policies – Regulatory Exclusion

Introduction

The collapse of the US credit markets, coupled with the likely increase in the insolvency rate of banking institutions, raises a variety of issues, including the strong possibility of litigation. Most lending institutions purchase insurance policies that provide coverage for their directors and officers. However, these policies often contain exclusions that may preclude coverage of which companies, directors and officers of lending institutions, in particular, need to be aware. These exclusions include a clause commonly known as the "regulatory exclusion." In short, any claims brought by a regulatory agency after it takes possession of an insolvent lending institution raise the possibility of personal liability on behalf of directors and officers otherwise covered by an insurance policy.

Does the Policy Cover Claims Brought by a Regulatory Agency?

Directors & Officers Liability Insurance (D&O) policies typically include protection for claims against individuals for mismanagement of a business. However, when the business in question is a bank, government agencies are often the party bringing the lawsuit against individual directors and

officers, thus triggering a regulatory exclusion clause. Unique to the banking industry, the Federal Deposit Insurance Corporation (hereinafter FDIC) may, under certain circumstances, be appointed conservator or receiver of a failing or struggling federal or state depository institution.¹

As of 1995, 50 to 75 percent of D&O liability insurance policies sold to banks included regulatory exclusion clauses.² The regulatory exclusion may exclude coverage for claims specifically "brought by or on behalf of the [FDIC], the Federal Savings and Loan Insurance Corporation..." or generally brought by any governmental, quasi-governmental or self-regulatory entity.³

Past Attempts at Dismissal and Future Implications

Initially, government agencies, as well as directors and officers, who were equally affected by the preclusion of insurance coverage under this exclusion, fought regulatory exclusion clauses using a mainly public policy argument; regulatory exclusions impair the ability of the government to seek redress in situations of a failed bank.⁴ However, the majority of courts held that parties' freedom to contract overrode the government agency's right to bring a claim against an insured individual.⁵ In *American Casualty Co. v. Sentry*

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Federal Savings Bank, for example, the court found clear Congressional intent regarding the favorable existence of contracting for regulatory exclusions.⁶ One court noted that it would not have been against public policy for banks to choose to purchase no D&O coverage at all and, therefore, excluding optional coverage in certain situations would clearly not fall against public policy.⁷

Depending on how the regulatory clause is worded, the insured might be able to argue that it is ambiguous. However, the bulk of courts have read regulatory clauses broadly—to encompass a variety of regulatory agencies, and literally, to include all cases—both direct and indirect lawsuits.⁸ Often insurance policies use language such as “based upon or attributable to,” which the courts agree is “awkward when used in conjunction with the language ‘any action or proceeding brought by or on behalf of the [FDIC].’”⁹ In these instances, courts have found that, reading the policy as a whole, the intent of the insured was to exclude coverage for losses resulting from actions brought by or on behalf of government agencies, including the FDIC.¹⁰ For example, in *American Casualty Co. v. Baker*, the court disagreed with the Resolution Trust Corporation’s (RTC) assertion that the agency existed in the sole capacity as liquidator and not in its governmental capacity.¹¹ In similar vein, in *FDIC v. Zaborac*, the court rejected the argument that the FDIC did not “bring” the action, but was merely “maintaining” the action on behalf of a third party.¹²

Conclusion

The foregoing exclusion is only one of the issues that may arise when a claim is brought by a regulatory agency. Any claims such as these should be discussed with your in-house counsel, risk manager or outside insurance coverage counsel, to ensure that all of your possible rights are protected. Moreover,

your insurance broker may be able to convince your company’s D&O carrier to delete or modify any exclusion in your policy that bars coverage for claims brought by a governmental entity.

Endnotes

¹ This may happen if, for example, the assets of the institution are insufficient to meet its obligations to its creditors, there is a substantial dissipation of assets or earnings due to a violation of statute or regulation or an unsafe or unsound practice, there is an inability for the institution to pay its obligation or meet its depositors’ demands in the normal course of business, or the institution has incurred losses that will deplete all or substantially all of its capital. 12 USCS § 1821(c)(5).

² Peter D. Rosenthal, Note: Have Bank Regulators Been Missing the Forest for the Public Policy Tree? 75 B.U.L. Rev. 155 (1995).

³ See, *American Casualty Co. v. Sentry Fed. Sav. Bank*, 867 F. Supp. 50, 54 (D. Mass. 1994).

⁴ *Id.* at 58.

⁵ *American Casualty Co. v. Sentry Fed. Sav. Bank*, 867 F. Supp. 50, 58 (D. Mass. 1994)(finding that regulatory exclusions were within the purview of appropriate public policy as there was no public policy prohibiting the right to contract out of insurance coverage); *FDIC v. Zaborac*, 998 F.2d 404, 410 (7th Cir. 1993); *Fidelity & Deposit Co. v. Conner*, 973 F. 2d 1236, 1243-44 (5th Cir. 1992) (noting that “this court joins the overwhelming majority of courts which...have ruled that regulatory exclusions are enforceable”); *FDIC v. American Casualty Co.*, 975 F. 2d 677, 680-82 (10th Cir. 1992); *St. Paul Fire and Marine Ins. Co. v. FDIC*, 968 F.2d 695, 702 (8th Cir. 1992) (finding that the regulatory exclusion does not violate public policy, especially in light of the FIRREA’s failure to establish an explicit public policy that would invalidate such an exclusion; *American Casualty Co. v. Rahn*, 854 F. Supp. 492, 500 (W.D. Mich. 1994) (holding that public policy “does not create insurance coverage that never existed.”)

⁶ *American Casualty Co. v. Sentry Fed. Sav. Bank*, 867 F. Supp. 50, 58 (D. Mass. 1994);

⁷ *Fidelity & Deposit Co. v. Conner*, 973 F. 2d 1236, 1243-44 (5th Cir. 1992).

⁸ See, *FSLIC v. Shelton*, 78 F. Supp. 1355, 1358 (M.D. La. 1992) (holding that the regulatory exclusion includes suits brought by the

FSLIC); *FDIC v. Zaborac*, 773 F. Supp. 137, 141 (C.D. Ill 1991) (noting "[c]learly, this exclusion was intended to bar any action brought or maintained by the FDIC or other regulatory agency"), *aff'd*, 998 F.2d 404 (7th Cir. Ill. 1993); *Powell v. American Casualty Co.*, 772 F. Supp. 1188, 1190 (W.D. Okla. 1991) (holding that the regulatory exclusion applies to the FDIC); *St. Paul Fire & Marine Ins. Co. v. FDIC*, 765 F. Supp. 538, 549 (D. Minn. 1991) (noting that "[t]he court follows the rationale of numerous other courts who have concluded that similar regulatory endorsements in D&O policies are unambiguous"), *aff'd*, 968 F.2d 695 (8th Cir. 1992). *But cf. FSLIC v. Heidrick*, 774 F. Supp. 352, 360-61 (D. Md.) (finding the regulatory clause to be ambiguous and barred only secondary suits, rather than those brought by the regulators), *reconsidered in part*, 812 F. Supp. 586 (D. Md. 1991), *aff'd*, 995 F.2d 471 (4th Cir. 1993); *FDIC v. Mijalis*, No. CIV-A-8-1316, 1992 WL 172677, at *14 (W.D. La. June 30, 1993) (holding that the regulatory exclusion clause was ambiguous as applied to the FDIC and, therefore, must be construed in favor of the insured in providing coverage).

⁹ See, *FDIC v. Zaborac*, 773 F. Supp. 137, 140-141 (C.D. Ill 1991).

¹⁰ *Id.*; *FSLIC v. Shelton*, 78 F. Supp. 1355, 1358 (M.D. La. 1992) (holding that the regulatory exclusion includes suits brought by the FSLIC); *Powell v. American Casualty Co.*, 772 F. Supp. 1188, 1190 (W.D. Okla. 1991) (holding that the regulatory exclusion applies to the FDIC).

¹¹ *American Casualty v. Baker*, 758 F. Supp. 1340, 1348 (C..D. Cal. 1991).

¹² 773 F. Supp. at 141.

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