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Client Alert

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The "Insured v. Insured" Exclusion in D&O Policies

"Financial institutions are encouraged to review their D&O liability policy with in-house counsels, risk managers or outside insurance coverage counsels to determine the breadth of the 'Insured v. Insured' exclusion."

Introduction

The credit market collapse has already claimed several financial institutions, which the US government has declared insolvent and placed into a Federal Deposit Insurance Corporation (FDIC) receivership. The insolvent institutions' former directors and officers now face potential lawsuits in which the FDIC or other regulatory agencies may allege that they were responsible for the insolvency of the now failed financial institution. Such former directors and officers may use their Directors' and Officers' (D&O) liability insurance to cover these lawsuits' legal expenses and any judgments or settlements. However, an exclusion known as the "Insured v. Insured" exclusion, that is found in most D&O policies, might preclude coverage. Just as in past lawsuits resulting from the Savings and Loan Crisis, D&O carriers may deny coverage, arguing that the "Insured v. Insured" exclusion applies to claims and suits brought by these regulatory agencies.

History of the "Insured v. Insured" Exclusion

D&O insurance was originally intended to protect corporate directors and officers from shareholder and third-party suits. Nevertheless, two lawsuits in the early 1980s resulted in D&O carriers creating the "Insured v. Insured" exclusion. In both *Bank of Am. v. Powers* and *Nat'l Union Fire Ins. Co. v. Seafirst Corp.*, the insured corporations sought to recover losses from improvident and/or unauthorized actions taken by their directors and officers who in turn made claims under their D&O policies.[1] Similarly, in *Bank of Am. v. Powers*, the officers were accused of "wrongful and negligent performance of their duties and responsibilities as bank officers and employees in connection with a series of mortgage-backed securities transactions."[2] In both cases, the D&O carriers argued that D&O policies did not cover claims by the insured corporation itself against its former directors and officers.

The *Bank of Am. v. Powers* case was settled, but the court in *Seafirst* concluded that the policy unambiguously covered the insured corporation's direct action against its directors and officers.[3] Under the policy, the insurer was to pay for losses from "any claim or claims" against directors and officers, which the court found included direct actions, and no other provision in the policy purported to preclude coverage.[4]

Thereafter, D&O carriers added an "Insured v. Insured" exclusion to their D&O policies to prevent such collusive, or so-called "friendly," lawsuits in which an insured corporation might force its insurer to pay for its officers' poor business decisions. The exclusion typically precludes coverage of claims by or on behalf of the insured corporation, its affiliates or directors and officers against other insureds under the applicable D&O policy.[5]

This heavily litigated exclusion continues to be at the heart of many insurance coverage disputes. Courts have held that an "Insured v. Insured" exclusion applies when the insurer demonstrates that the complaint's allegations place the claims squarely within the exclusion's language.[6] In determining whether the allegations fall within the exclusion, courts often consider the exclusion's rationale, and refuse to apply exclusionary clauses when the underlying action is not collusive.[7]

The "Insured v. Insured" Exclusion in the Receivership Context

The applicability of the "Insured v. Insured" exclusion was first tested in the context of failed savings and loan and other financial institutions in the late 1980s and early 1990s. When several hundred failed institutions were placed in receivership, the Federal Savings and Loan Insurance Company (FSLIC) at the time, later the FDIC, liquidated these institutions' assets and distributed the proceeds to creditors. Frequently, the receiver also filed civil lawsuits against directors and officers of institutions it believed had been "mismanaged" to maximize the receivership estate. D&O carriers invoked the "Insured v. Insured" exclusion to escape liability and argued that suits by receivers against directors and officers fundamentally equaled suits by the corporation itself against its directors and officers. Thus, courts had to decide whether receivers were in fact "Insureds" under such policies and thus barred from recovering insurance proceeds.

Most decisions addressing the applicability of the "Insured v. Insured" exclusion in this context concluded that the exclusion did not bar lawsuits by the FDIC or the FSLIC against former directors and officers of the failed financial institutions.[8] For example, in *Fidelity & Deposit Co. of Maryland v. Zandstra*, a failing institution filed two actions against its directors and officers, which the FSLIC, as the institution's receiver, assigned to itself, in its corporate capacity.[9] Following another assignment of the claims, the FDIC became the plaintiff in both actions. When the defendants tendered their defense of the actions to Fidelity, the D&O policies' insurer, it declined coverage invoking the "Insured v. Insured" exclusion.[10] However, the court sided with the FDIC and the director and officer defendants.

The court noted that the "obvious intent" behind the "Insured v. Insured" exclusion was to protect Fidelity against collusive suits among the institution and its directors and officers and that the FDIC, the assignee by operation of law, was a genuinely adverse party to the director and officer defendants.[11] Thus, the FDIC's involvement in the actions was not collusive. The court also held that the FDIC did not strictly "step into the shoes" of the failed institution, since it could bring suit both as the institution's successor and as its creditor, as well as on behalf of the institution's creditors and shareholders, and as subrogee to depositors' rights against the institution.[12]

A few cases, however, extended the "Insured v. Insured" exclusion to the FSLIC/FDIC because the courts concluded that the regulatory agency pursued claims against directors and officers on its own behalf, "standing in the shoes" of the institution.[13] The FDIC had argued the exclusion should not apply because it performed many functions and represented not only the failed financial institution and its shareholders, but also its depositors, creditors, the deposit insurance fund and the public at large.[14] This position was rejected because, the courts concluded, any recovery by the FDIC in its corporate capacity on claims it purchased from itself as Liquidating

Agent would only inure to itself, and not to the benefit of the failed institution's depositors, creditors or shareholders.[15]

Conclusion

Zandstra and subsequent decisions support how courts may interpret the "Insured v. Insured" exclusion in future litigation. First, a court may analyze whether the FDIC is a genuinely adverse party to the director and officer defendants, to exclude any collusion risk. Second, the identity of the original claimant may not determine the exclusion's applicability, even where the original lawsuit would be prohibited under the "Insured v. Insured" exclusion. Finally, a court may assess whether the FDIC brings the claims against the directors and officers on its own behalf, or also on behalf of other constituents, as the failed institution's depositors, creditors and shareholders. If the court concludes that the FDIC represents its own interests "standing in the shoes" of the failed financial institution, and would exclusively benefit from any recovery, then the "Insured v. Insured" exclusion may bar coverage and potentially expose director and officer defendants to substantial personal liability.

Financial institutions are encouraged to review their D&O policy with in-house counsels, risk managers or outside insurance coverage counsels to determine the breadth of the "Insured v. Insured" exclusion. Should the exclusion be broad enough to potentially limit coverage in the event of a lawsuit by the FDIC, the institution should seek the assistance of its insurance broker to attempt to limit the exclusion's breadth.

Endnotes

1 *See* Complaint in *Bank of Am. v. Powers*, No. C 536-776 (Cal. Super. Ct. filed Mar. 1, 1985), *reprinted in* David W. Ichel & Sharon O. Thompson, *Directors' and Officers' Insurance Coverage: An Overview and Current Issues*, 1 Sec. Litig. 257, 349-85 (Sept.-Oct. 1987); *Nat'l Union Fire Ins. Co. v. Seafirst Corp.*, 1986 US Dist. LEXIS 28065 (W.D. Wash. Mar. 18, 1986).

2 *See* Peter Waldman, *Bank of America Settles Suits Tied to Losses, Posts Gain on Sale of Bank-Firm Stake*, Wall St. J., Jan 5, 1988, at 12.

3 *See Nat'l Union Fire Ins. Co. v. Seafirst Corp.*, 1986 US Dist. LEXIS 28065, at *15.

4 *See id.*

5 Originally, the feelings of D&O carriers on this issue ran so strong that early versions of this exclusion seemed to exclude even derivative suits, which are technically brought in the name of the insured corporation. Most policies today expressly recognize that shareholder derivative actions are not to be excluded.

6 *See, e.g., Bodewes v. Ulico Cas. Co.*, 336 F. Supp. 2d 263, 273 (W.D.N.Y. 2004), *aff'd, Burke v. Ulico Cas. Co.*, 165 Fed. Appx. 125 (2d Cir. N.Y. 2006).

7 *See id.* at 275-77 (finding the exclusionary clause inapplicable because the action was not "collusive litigation brought for the purpose of imposing upon the insurance company the responsibility of making up for the . . . operational losses").

8 *See, e.g.*, *FSLIC v. Mmahat*, 1988 US Dist. LEXIS 7136 (E.D. La. June 29, 1988); Am. *Cas. Co. v. FSLIC*, 704 F. Supp. 898 (E.D. Ark. 1989); *Cont'l Cas. Co. v. Allen*, 710 F. Supp. 1088 (N.D. Tex. 1989); *Branning v. CNA Ins. Co.*, 721 F. Supp. 1180 (W.D. Wash. 1989); *Am. Cas. Co. v. FDIC*, 1990 US Dist. LEXIS 6065 (N.D. Iowa Feb. 26, 1990); *Finci v. Am. Cas. Co.*, 572 A.2d 1092 (Md. Ct. Spec. App. 1990); *Fidelity & Deposit Co. of Maryland v. Zandstra*, 756 F. Supp. 429 (N.D. Cal. 1990); *FDIC v. Zaborac*, 773 F. Supp. 137 (C.D. Ill. 1991); *Am. Cas. Co. of Reading, Pa. v. Baker*, 758 F. Supp. 1340 (C.D. Cal. 1991); *Am. Cas. Co. of Reading, Pa. v. Sentry Fed. Sav. Bank*, 867 F. Supp. 50 (D. Mass. 1994).

9 756 F. Supp. 429 (N.D. Cal. 1990).

10 The exclusion provided as follows:

> It is understood and agreed that the Company shall not be liable to make any payment for Loss in connection with any claim made against the Directors and Officers by any other Director or Officer of the Association or by the Association, except for a shareholders' derivative action by a shareholder of the Association, when such shareholder is not a Director or Officer of the Association.

11 *Id.* at 431-32.

12 *Id.* at 432-33.

13 *See Mt. Hawley Ins. Co. v. FSLIC*, 695 F. Supp. 469, 482 (C.D. Cal. 1987); *Gary v. Am.*

Cas. Co. of Reading, 753 F. Supp. 1547, 1555 (W.D. Okla. 1990).

[14] *See Gary*, 753 F. Supp. at 1554.

[15] *See Mt. Hawley*, 695 F. Supp. at 482 n.2; Gary, 753 F. Supp. at 1555 n.7. *See also Evanston Ins. Co. v. FDIC*, 1988 US Dist. LEXIS 16263, at *4 (D.C. Cal. 1988). In *Evanston*, the underlying action did not purport to enforce the rights of creditors; it was based on negligence, and the FDIC asserted that the directors breached the duty of care owed by them to the institution. The exclusion exception for derivative suits did not contemplate claims that "could be" or "potentially were" derivative claims.

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