Client Alert

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11th Circuit Decision Highlights D&O Policy Selection Dilemma for Financially Distressed Companies

"The Parent Bank entered into this insurance contract with its eyes wide open and its wallet on its mind."

With the above summation of the factual backdrop, the US Court of Appeals for the Eleventh Circuit recently held that an insurer properly denied coverage under a "prior acts" exclusion in a directors and officers (D&O) insurance policy that a bank holding company purchased shortly before filing bankruptcy. Faced with two policy options with different levels of coverage, the company's executives selected the policy with the exclusion in exchange for a substantially lower premium. Following a Chapter 11 bankruptcy filing, the bankruptcy plan administrator for the bank holding company sought recovery of $46 million from two bank executives. The executives settled the claims and assigned their rights under the D&O policy to the administrator. However, the insurer denied the claims, leaving the executives solely responsible for a $15 million payment under the settlement. The plan administrator then sued the insurer, challenging the insurer's coverage denial under the "prior acts" exclusion. The appellate court found that the exclusion was legally enforceable and the product of calculated decision by the bank to use the money saved from the lower premiums for other business purposes.

The decision underscores the inherent challenge faced by many policyholders when selecting coverage—protecting the bottom line and mitigating future risk—a challenge that may be made even more difficult when the policyholder is struggling financially and is subject to broad policy exclusions.

BankUnited's Fateful Decision

The facts that preceded BankUnited's demise follow the well-worn paradigm arising out of the great recession. BankUnited was the parent company of BankUnited FSP, a federally chartered savings bank. By November 2008, both were in serious financial trouble. BankUnited attempted to recapitalize its subsidiary bank with $80 million in fresh capital. Shortly thereafter, a group of investors filed a class action against several of BankUnited's corporate officers alleging securities law violations related to misstatements about underwriting standards. Around the same time as the litigation, BankUnited entered into stipulations with the Office of Thrift Supervision (OTS) that the bank had "engaged in unsafe and unsound practices."

Concurrently with the litigation and the OTS stipulation, BankUnited's insurer declined to renew its D&O policy. BankUnited found a new insurer in U.S. Specialty, willing to offer replacement coverage but with substantially increased premiums as a result of the bank's precarious financial condition. In fact, U.S. Specialty's underwriter acknowledged that the offer of D&O coverage to BankUnited was an "opportunistic play." U.S. Specialty offered two coverage choices: one with a "prior acts" exclusion, barring coverage for losses attributable to conduct of the bank's directors and officers prior to date of coverage, and one without the exclusion. The policy without the exclusion would cost $300,000 in additional premium. UnitedBank elected the policy *with* the exclusion, but requested an increased coverage limit from $10 million to $20 million.

The Bankruptcy Litigation

As the bank struggled with the fallout from the great recession, BankUnited officers approved two transfers to the subsidiary bank, totaling $46 million, each of which were tax refunds that were owed to the parent company. The two transfers occurred after the effective date of the U.S. Specialty D&O insurance policy. These transfers proved insufficient to recapitalize the bank and in May 2009, OTS closed the subsidiary bank and appointed the FDIC as receiver. One day later, parent BankUnited filed bankruptcy under Chapter 11 of the Bankruptcy Code.

The bankruptcy plan administrator filed a lawsuit against three BankUnited executives, alleging various breaches of fiduciary duty claims arising from their "fail[ure] to implement and maintain effective risk management procedures and internal controls." The plan administrator also sought to recover from two former executives the $46 million in tax refunds that BankUnited transferred to its subsidiary bank. U.S. Specialty was notified of these claims and issued a coverage denial letter under the prior acts exclusion. The plan administrator then settled his fraudulent transfer claims relating to the tax refunds and received an assignment of the executives' rights under the U.S. Specialty policy.

The Lawsuit Against U.S. Specialty

With that assignment in hand, the plan administrator sued U.S. Specialty based on its denial of coverage as to the underlying claims. On cross-motions for summary judgment, the U.S. District Court for the Southern District of Florida held that the "prior acts" exclusion did bar coverage for the fraudulent transfer. The district court reasoned that the "prior acts" exclusion was very broad based on the use of "arising out of" language therein. Applying that language, the district court determined the "prior acts" exclusion barred coverage for the fraudulent transfer count because the specific allegations depended on allegations of insolvency, which necessarily predated the policy inception date.

The plan administrator appealed, arguing that insolvency itself was not an inherently wrongful act that could trigger the exclusion. The Eleventh Circuit focused, however, on what had been plead in the complaint and the count at issue relied on the insolvency to support the allegations of the Bank's officers' and directors' alleged misconduct. The Eleventh Circuit also rejected the plan administrator's argument that coverage was illusory if the insurer's construction of the "prior acts" exclusion had been adopted; instead, the court found that the "prior acts" exclusion "excludes a lot of coverage, but not all coverage," and that BankUnited was fully aware of the potential implications of the exclusion when it selected the cheaper (and, ultimately, more risky) coverage.

Conclusion

For corporate directors, including those facing financial distress, the cost of insurance is always a concern—and rightly so. But selection of policy conditions based on premium alone, especially when facing insolvency that may inspire shareholder litigation, government inquiry, or avoidance actions with long look-back periods, can cause insurmountable hurdles to coverage at a later date. This is particularly true with respect to the "prior acts" exclusion and other policy exclusions that are prefaced on language that has been construed by some courts to have broad-ranging effect. Policyholders should therefore consider consulting experienced coverage counsel to help determine appropriate policy language and, in particular, assist in assessing under potentially applicable law the breadth that may be given to critical policy terms, such as those predicated on some causal or relational nexus.

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