

Byline

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Most Courts Limit Scope of Insured v. Insured Exclusion

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On Oct. 8, 2014, in *St. Paul Mercury Ins. Co. v. Michael S. Hahn, et al.*, Case No. SACV 13-0424 AG (RNBx), a California district court ruled that St. Paul Mercury Ins. Co., referred to as Travelers, must defend former directors and officers of a defunct bank who were sued by the Federal Deposit Insurance Corporation – as the receiver for Pacific Coast National Bank – against claims of negligence and breaches of fiduciary duty. The district court rejected Travelers’ reliance on the insured v. insured exclusion to escape coverage and, in the process, aligned itself with the majority of courts throughout the

country that have held the exclusion does not unambiguously exclude from coverage lawsuits by the FDIC.

Background

In November 2009, the Office of the Comptroller of the Currency closed Pacific Coast National Bank and appointed the FDIC as its receiver. Shortly thereafter, the FDIC sued several of the bank’s former directors and officers for negligence, gross negligence and breaches of fiduciary duty. The defendant directors and officers tendered the lawsuit and sought coverage pursuant to Travelers’ “Management Liability Insuring Agreement,” which provided coverage for “loss for which the Insured Person [including the directors and officers] ... become legally obligated to pay on account of any claim ... for a management practices act.”

Travelers denied coverage, relying on the insured v. insured exclusion, which states that “the insurer shall not be liable for loss [including defense costs] on account of any claim made against any insured ... brought or maintained by or on behalf of any insured or company [including the bank] in any capacity, except: (a) a claim that is a derivative action brought or maintained on behalf of the company by one or more persons who are not directors or officers and who bring and maintain such claim without the solicitation, assistance or active participation of any director or officer.”

In evaluating cross-motions for summary judgment, the court’s main consideration was whether the FDIC, as the receiver, had brought the lawsuit “on behalf of” the bank and, therefore, subject to the insured v. insured exclusion.

Ruling

In denying Travelers’ motion, thus granting the FDIC’s motion, the district court held that the phrase “on behalf of” is ambiguous when applied to the role of the FDIC and, therefore, determined that Travelers owed

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a duty to defend. The court rejected Travelers' argument that the insured v. insured" exclusion applies because the FDIC "stands in the shoes" of the failed bank when it acts as a receiver.

Despite the U.S. Supreme Court's decision in *O'Melveny & Myers v. FDIC* that the FDIC as receiver "stands in the shoes" of the failed bank, the court explained that the Supreme Court's decision does not "tell us whether 'on behalf of' means the same thing as 'stands in the shoes.'" The district court noted that other courts considering the insured v. insured exclusion have reached varying conclusions and, by definition, the varying results confirm that the insured v. insured exclusion was ambiguous and subject to different interpretations. "There can be little doubt that repeated disputes over the "Insured vs. Insured" exclusion have placed insurers on notice that it is ambiguous."

District Judge Andrew J. Guilford also properly noted the importance that "exclusionary clauses are interpreted narrowly against the insurer" and exclusionary clauses will be enforced only if they are conspicuous, plain and clear. Here, the phrase "on behalf of" was far from clear and conspicuous and Travelers had not met its burden to prove the applicability of the exclusion. The court alluded to the fact that Travelers had the opportunity to make clear in the policy that the insured v. insured exclusion did apply to the FDIC, and could have done so by utilizing an optional regulatory exclusion that explicitly names the FDIC. The court determined that Travelers chose not to include such a provision here and, therefore, "Travelers cannot now benefit from the ambiguity."

Implications

The St. Paul Mercury decision is consistent with the majority of decisions throughout the country that have refused to exclude coverage based on carriers' attempts to assert the insured v. insured exclusion. Courts understand that because of the multiple roles in which the FDIC acts in pursuing claims against the former directors and officers of a failed bank, there is ambiguity on the question of whether a lawsuit brought by the FDIC, as the receiver, should trigger the insured v. insured exclusion. As a result of the 2008 financial crisis, several financial institutions have faced similar issues as raised in the St. Paul Mercury decision and insurance coverage may be the only viable resource that these former directors and officers have to mount a sufficient defense and to pay any ultimate judgments.

This decision also confirms the important policy interpretation standard that policy provisions that are capable of two or more reasonable constructions must be interpreted to protect the objectively reasonable expectations of the policyholder. As the court explained, "any ambiguity or uncertainty in an insurance policy is to be resolved against the insurer," and construing ambiguities "to benefit insurers would thus create perverse incentives." Exclusionary clauses should be enforced against a policyholder only if such clauses are conspicuous, plain and clear.

St. Paul Mercury is another reminder that policyholders should not accept a carrier's reflexive decision to assert potentially ambiguous exclusions to avoid coverage. Policyholders should carefully consider all coverage denials and push back, where appropriate, particularly where the policy provision on which the denial is based may be subject to more than one reasonable interpretation.