HOW A BANK FAILURE AFFECTS INSURANCE COVERAGE

Edward F. Donohue

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I. INTRODUCTION

This article discusses how the takeover of a financial institution by a receiver affects the coverage available under insurance policies that are in place at the time the receiver is appointed. Generally, the two most important insurance contracts impacted by a change in control after a bank failure are the bank's financial institution bond and the directors and officers liability policy. However, similar principles apply to first and third party insurance contracts of other types.

A financial institution as a going concern does not look to insurance to improve its balance sheet. Insurance is a risk management tool designed to protect against fortuitous losses and unexpected liabilities of a going concern. That objective informs the actual and reasonable expectations of the bank and the insurer at the time the policies are issued.

When a bank fails a stranger to the policyholder relationship assumes control. The charge of a receiver is to marshal assets and supervise the orderly liquidation of the institution. Insuring a failed concern under the management of government officials represents a materially different underwriting risk. Continuing insurance coverage after the bank discontinues operations is not contemplated by the parties to the original policyholder relationship. As such, successor rights are generally fixed as of the date of the takeover and derivative of those of the institution prior to that time. Coverage is eliminated prospectively under the automatic termination provisions of financial institution bonds and directors and officers liability policies.

As a general matter, the FDIC as receiver does not attain the status of an involuntary substitute insured as to loss that is discovered or claims that are made after the time the receiver is appointed. Nor should the FDIC achieve rights superior to those of the institution at the time it assumes control. Nevertheless the receiver will frequently attempt not merely to preserve assets but to improve on the position of the insured as of the date of closure.

In some areas the FDIC can legitimately rely upon the shelter of federal law to, in effect, enhance its rights over those of the institution. In others there is reasonable debate as to whether arguments made by the FDIC to support claims for coverage in the past will succeed in the future. In still others, there are practical obstacles to the FDIC's ability to recoup loss through insurance. It is inherently more difficult for the agency to investigate claims from second hand sources less familiar to its employees as opposed to those of the bank. Coverage must also be investigated quickly to avoid a forfeiture given policy provisions that provide for lapse in the event of a change in control.

In the case of a financial institution bond the receiver stands in the shoes of the insured institution as to loss that was discovered before the time of the receivership. Automatic termination provisions are triggered when the bank fails. These provisions are designed to maintain the status quo as to the institution's coverage under the bond up until the date of the receivership but eliminate coverage thereafter.

In the case of directors and officers liability insurance the FDIC may pursue insurance coverage claims in two diametrically opposed capacities.

On the one hand, as a successor, the FDIC may be entitled to the continued protection of third party liability insurance. Coverage for third party claims brought against the institution prior to closure may continue to apply. This may include post-receivership lawsuits that were the subject of timely potential claim notices before the liability policy expired.

On the other hand, the FDIC more frequently appears as an adverse claimant prosecuting claims against bank officers and directors under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). However, because of the materially changed conditions and underwriting risks after bank failure, many liability policies contain provisions that limit or exclude coverage after a receivership.

This paper discusses the potential availability of liability coverage to the FDIC as a defendant in cases prosecuted by depositors, creditors and other third parties after a failure. Common conditions or exclusions are also discussed that may apply when the FDIC appears as a plaintiff pursuing FIRREA claims against former officers and directors.

II. JURISDICTION

A. Federal Court Jurisdiction and Removal

The authority of the FDIC to enforce the contracts of a failed financial institution is established in the corporate powers provision of FIRREA, 12 U.S.C. Section 1819(a). The statute

establishes the right to "sue or be sued" on the contractual rights and obligations of the failed institution.[1] The specific right to recover under a policy based on claims that the institution may have had as of the day of closure derives from 12 U.S.C. Section 1821(d)(2)(A). This statute provides that the FDIC "succeeds to all rights, titles, powers, and privileges of the insured depository institution."[2] Under Section 1819, most of such claims trigger federal subject matter jurisdiction and thus can be brought in federal court.[3] Claims brought by the FDIC are deemed to "arise under the laws of the United States" supporting federal question jurisdiction whether the FDIC sues as a receiver or in any other capacity.[4] Thus, a previously broad "state action" exception applicable to claims brought by the FDIC as receiver was eliminated in 1989 under FIRREA.[5]

Nevertheless, there is a broad jurisdictional modification provision under Section 1819 that, at first blush, might lead to the conclusion that many if not most post-receivership coverage claims should be resolved in state court. Section 1819(b)(2)(D) establishes a more limited state action exception which may defeat original jurisdiction and possible removal to federal court if all of its requirements are met. Federal question jurisdiction and removal may not lie in a case….

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[1] *Village of Oakwood v. State Bank and Trust Co.*, 539 F.3d 373, 378 (6th Cir. 1998).

[2] *FDIC v. St. Paul Companies*, 634 F. Supp. 2d 1213, 1219 (D. Colo. 2008) (FDIC "steps into the shoes" of the depository institution as to rights under financial institution bond as of the day of closure).

[3] 12 U.S.C. § 1819(b)(2)(A); *Resolution Trust Corp. v. Fidelity & Deposit Co. of Maryland*, 205 F.3d 615, 626 (3d Cir. 2000).

[4] *Demars v. First Service Bank for Savings*, 907 F.2d 1237, 1241 (1st Cir. 1990) (Discussing addition of Section 209 of FIRREA, which had previously eliminated suits by the corporation in its capacity as a receiver from the broad grant of federal subject matter jurisdiction found in the current statute).

[5] *Demars,* 907 F.2d at 1241-42, *citing* 12 U.S.C. § 1819(b)(2)(E) (Providing that state action exception shall not be construed to limit right of the FDIC to invoke the jurisdiction of any United States District Court where the FDIC has been appointed receiver).

> (i) to which the Corporation, in the Corporation's capacity as receiver of a State insured depository institution by the exclusive appointment by State authorities, is a party other than as a plaintiff;
>
> (ii) which involves only the preclosing rights against the State insured depository institution, or obligations owning to, depositors, creditors, or stockholders by the State insured depository institution; and
>
> (iii) in which only the interpretation of the law of such State is necessary.
>
> shall not be deemed to arise under the laws of the United States.[6]

In order for this exception to apply, all three conditions must exist.[7] Thus, if the bank was a plaintiff in a pre-existing state court coverage action brought before a receivership, removal thereafter could be barred in some cases.

However, even if the financial institution is a defendant in a state court coverage action that deals exclusively with state law questions, the potential to remove exists. The state law exception is narrowly construed. There is a presumption the agency is entitled to litigate in federal court.[8] Even where the agency raises a colorable defense under federal law, such as the *D'Oench Duhme* defense, codified at 12 U.S.C. Section 1283(e) of FIRREA, the state law exception does not apply.[9] It is not uncommon for the agency to raise to Section 1823(e) as a defense in coverage litigation particularly in rescission cases.[10]

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[6] 12 U.S.C. § 1819(b)(2)(D).

[7] *See e.g., In re Southern Industrial Banking Corp.*, 872 F.2d 1257, 1260 (6th Cir. 1989); *FDIC v. Nichols*, 885 F.2d 633, 636 (9th Cir. 1989).

[8] *Reding v. FDIC*, 942 F.2d 1254, 1257-58 (8th Cir. 1991).

[9] *Id.; Diaz v. McAllen State Bank*, 975 F.2d 1145, 1148-49 (5th Cir. 1992).

[10] *FDIC v. Oldenburg*, 34 F.3d 1529, 1554 (10th Cir. 1994).

In addition, if the state action exception applies, there is still a potential mechanism the FDIC relied upon before FIRREA was enacted to establish federal question jurisdiction. The FDIC can assign rights in its receivership capacity to itself in its corporate capacity to prosecute claims.[11] Arguably the agency has no lesser right to assign insurance coverage or other claims it may inherit as receiver for further prosecution in its corporate capacity since the passage of FIRREA. As in any instance of forum shopping, a court could look behind the assignment.[12]

In any case, post-receivership coverage actions will be prosecuted in federal court in most cases unless the FDIC opposes federal jurisdiction. Limitations on removal do not apply to lawsuits filed after closure. Even if the underlying coverage dispute is governed exclusively by state insurance law, when the FDIC is a plaintiff there is federal jurisdiction and the agency has the right to initiate lawsuits in federal court.[13]

In some instances, the FDIC may calculate that state court is a more favorable forum and file or continue the case in that venue.[14] For example, in *FDIC v. American Casualty of Reading*,[15] the FDIC successfully steered clear of the existing unfavorable Tenth Circuit precedent rejecting

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[11] *FDIC v. Nichols*, 885 F.2d 633, 636-37 (9th Cir. 1989); *FDIC v. Braemoor Associates*, 686 F.2d 550, 552-53 (7th Cir. 1982).

[12] *E.g., Dweck v. Japan CBM Corp.*, 877 F.2d 790, 792 (9th Cir. 1989).

[13] *E.g., Resolution Trust Corp. v. Fidelity & Deposit Co. of Maryland*, 205 F.3d at 627. (Noting that most such coverage actions have been decided by federal courts.)

[14] *E.g., FDIC v. American Cas. Co. of Reading, PA*, 843 P.2d 1285, 1290 (Colo. 1992) (Garnishment action under directors and officers liability policy); *National Union Fire Ins. Co. of Pittsburgh, PA v. FDIC*, 1990 WL 50721 (Tenn.App. 1990) (Coverage question certified by federal court for review by Tennessee Supreme Court notwithstanding that *D'Oench* defense involved).

[15] 843 P.2d 1285 (Colo. 1992).

prior public policy attacks on regulatory exclusions in directors and officers liability policies.[16] By pursuing the action exclusively in Colorado state court, the agency successfully challenged a regulatory exclusion under state law.[17]

In such instances, the carrier may consider removal at the outset of the case if it deems the federal court for that district a more favorable forum. However, the liberal removal provisions of FIRREA is a door that swings in one direction.[18] As the First Circuit Court of Appeals recognized in *FDIC v. Cabral*, the broad and unusual removal provisions of FIRREA are only intended for the benefit of the bank regulatory authorities.[19] Normally an insurer may only remove when it is a *defendant*, at the *inception of the litigation*, when there is a recognized basis to remove.[20] Since federal question subject matter jurisdiction exists under Section 1819 whenever the FDIC is a *plaintiff*, suing in any capacity, an insurer will be able to remove a new coverage action brought by the FDIC as receiver in state court if it so chooses.[21]

However, that removal right pales in comparison to that of the FDIC under FIRREA. Under Section 1819(b)(2)(B), the FDIC may remove a case in which it is joined as a party, whether it is a defendant *or a successor plaintiff* to the institution.[22] Moreover, the agency is not constrained

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[16] 843 P.2d at 1291, 1296, Erickson, concurring and dissenting, N. 2, *citing, FDIC v. American Cas. Co. of Reading, PA*, 975 F.2d 677 (10th Cir. 1992) (Upholding regulatory exclusion as not violating federal public policy).

[17] 843 P.2d at 1294-95.

[18] *FDIC v. Cabral*, 989 F.2d 525, 526 (1st Cir. 1992).

[19] *Id.*

[20] *Id.*

[21] *Id., citing*, 28 U.S.C. § 1441.

[22] *Cabral*, 989 F.2d at 526.

by the normal thirty day from filing of the initial pleading rule of 28 U.S.C. Section 1446.[23] The agency is afforded 90 days to remove from the time the suit is filed or "the Corporation is substituted as a party."[24] This means the FDIC can file an intervention motion in any state court coverage action both long after the case is filed and long after it is appointed as receiver.[25] As a result, the agency has successfully sought removal as late as the time judgment has already been entered after trial.[26] In a recent case, the FDIC as receiver for Washington Mutual successfully removed a case to federal district court after the underlying collection case had been fully prosecuted and was pending on appeal before the Ohio Supreme Court.[27] The fact that diversity or federal subject matter jurisdiction was absent at the time of filing is irrelevant.[28] Further, once the federal district court assumes jurisdiction, its jurisdiction covers the entire case and controversy.[29]

B. Exhaustion of Administrative Remedies

Another unique jurisdictional question that arises after the appointment of a receiver is whether the administrative exhaustion procedures of 12 U.S.C. Section 1821(d)(13) of FIRREA apply. The provision requires application for claims that seek to determine rights in the assets of the

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[23] 28 U.S.C. § 1446(b).

[24] 12 U.S.C. § 1819(b)(2)(B).

[25] *Buczkowski v. FDIC*, 415 F.3d 594, 595 (7th Cir. 2005); *Heaton v. Monogram Credit Card Bank of Ga.*, 297 F.3d 416, 425-26 (5th Cir. 2002).

[26] *J.E. Dunn Northwest, Inc. v. Salpare Bay, LLC*, 2009 WL 3571354 (D. Or. 2009).

[27] *FDIC v. Beatley*, 2011 WL 665448, 5 (S.D. Ohio, February 11, 2011).

[28] *Village of Oakwood v. State Bank & Trust Co.*, 481 F.3d 364, 368-69 (6th Cir. 2007).

[29] *FSLIC v. Frumenti Dev. Corp.*, 857 F.2d 665, 666-67, N. 1 (9th Cir. 1988) (Comprehensive federal jurisdiction arises as to all claims).

failed institution through the administrative claims allowance protocol.[30] There is very limited authority on this point and, in practical fact, dozens of declaratory relief actions against the bank regulatory agencies have been litigated to conclusion with no indication the issue was ever raised.[31] Yet, the potential defense of waiver of the exhaustion requirement by the agency has only been recognized in the case of actions that were already pending when the receiver was appointed.[32]

In *National Union Fire Insurance Company v. City Savings F.S.B.*,[33] two financial institution bond insurers attempted unsuccessfully to sue for rescission in a declaratory relief action filed in federal district court.[34] The district court held that there was no jurisdiction in light of the exhaustion provisions.[35]

The Third Circuit Court of Appeals affirmed. The Court reasoned that, because the bonds were assets of the failed institution and the rescission actions sought to terminate the policies as assets of the institution, in exchange for a refund of premium, administrative exhaustion was required.[36] Though the declaratory relief actions were essentially *defensive* to the receiver's

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[30] 12 U.S.C. § 1821(d)(13)(D).

[31] *E.g., American Cas. Co. of Reading, PA v. FDIC*, 39 F.3d 633 (6th Cir. 1994) (Interpretation of regulatory exclusion in D&O policy); *American Cas. Co. of Reading, PA, v. FDIC*, 16 F.3d 152 (7th Cir. 1994) (Interpretation of regulatory exclusion in D&O policy).

[32] *FDIC v. Lacentra Trucking, Inc.*, 157 F.3d 1292, 1306-07 (11th Cir. 1998).

[33] 28 F.3d 376 (3d Cir. 1994).

[34] 28 F.3d at 381.

[35] *Id.*

[36] 28 F.3d at 388.

proofs of claim under the bonds, the claim allowance protocol was held to apply and preclude filing in court.[37]

In light of this authority, the safest course of action in declining a bond claim may be to file administratively and wait out the 180 day period formal disallowance for resolving claims.[38] However, several courts have refused to follow the *City Savings F.S.B.* decision. In *National Union Fire Insurance Co. of Pittsburgh v. Midland Bancor, Inc.,*[39] the district court initially dismissed a rescission count based on failure to exhaust administrative remedies and then reversed itself on a motion to reconsider under Rule 59.[40] Analogizing the post-receivership claims allowance protocol to similar provisions under the Bankruptcy Code, the court held that the procedure was limited to claims by creditors seeking affirmative recoveries against the assets of the defunct institution.[41] Requiring an insurance company to pursue "claims" that coverage was not available was held akin to requiring the prosecution of affirmative defenses through the claims adjustment procedure.[42] Relying on the Tenth Circuit Court of Appeals decision in *Homeland Stores v. RTC*,[43] the court noted the claims allowance procedure was not intended to cover such actions.[44] The court concluded the *City Savings F.S.B.* court inadequately addressed due process issues:

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[37] *Id.,* at 390-93.

[38] *See e.g., National Union Fire Ins. Co. of Pittsburgh v. Midland Bancor, Inc.*, 854 F.Supp. 782, 787 (D. Kan. 1994) (Maximum 180 day period expired after notice of rescission).

[39] 869 F.Supp. 880 (D. Kan. 1994).

[40] *Id.,* at 888.

[41] *Id.,* at 885-86, *citing, In re Parker North American Corp.*, 24 F.3d 1145, 1148 (9th Cir. 1994).

[42] *Id.*, at 866-887.

[43] 17 F.3d 1269 (10th Cir.) *cert den.*, 513 U.S. 928 (1994).

[44] 869 F.Supp. at 887-88.

> [t]he problem with applying such a rationale to a case such as this is that a claim on the policy may be made against National Union by a party other than the RTC. In that situation, National Union would be able to raise its defense, but would be unable to bring in all the parties which have an interest in the policy. As a result, National Union would face the prospect of piecemeal litigation and possible inconsistent judgments, the very hazards that declaratory judgment actions are intended to avoid.[45]

Although this observation was legitimate, the district court overlooked a significant difference between the policy before it and the bonds that were the subject of *City Savings F.S.B.* It could not be reasonably disputed that the bonds were assets of the estate because the bank's losses were insured directly under the bonds. The bonds provided first party insurance coverage. However, the district court in *Midland Bancor* treated the directors and officers liability policy, a third party liability policy, as a receivership asset. The court failed to consider that the RTC was an anticipated *adverse third party claimant* and not an insured.[46] At best, there is an argument that administrative exhaustion is required when an insurer contests its obligation to defend the FDIC as to third party claims for which it is potentially insured as a successor to the institution.[47] Where the receiver is not the insured but an anticipated claimant, there is no basis to treat a third party policy as an asset and thus subject to the claims allowance protocol.[48]

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[45] 869 F.Supp. at 887.

[46] 869 F.Supp. at 884.

[47] *See, e.g., In re Minoco Group of Companies, Ltd.*, 799 F.2d 517, 519 (9th Cir. 1986) (Third party claimants have no rights under liability policies. To the extent D&O policy may reduce unsecured claims against debtor, policy may be treated as estate asset). *Matter of Vitek, Inc.*, 51 F.3d 530, 534 (5th Cir. 1995) (Where policy only insures directors and officers, it is not an asset of the corporation).

[48] *Id.*

Nevertheless, in the case of bonds and other first party policies, the reasoning of *Midland Bancor* is sound.[49]

Finally, there has been unanimity that administrative exhaustion does not apply to affirmative defenses an insurer may raise when it is a defendant, a principle acknowledged by the *City Savings F.S.B.* court as well.[50]

III. STANDING

A. Bond Claims

The FDIC has the right to seek recovery of the proceeds of bond or other first party insurance or claims that are perfected as of the time of takeover.[51] As discussed in Section V., *infra*, provisions for termination at the time of a takeover prospectively eliminate financial institution bond coverage for regulators or other successors as substitute involuntary insureds. They are not intended to create a windfall to the surety of avoiding payment on a loss the bank had actually discovered prior to closure and for which the institution might have otherwise been indemnified had it not failed.

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[49] In *American Cas. Co. of Reading, PA v. Sentry Federal Savings Bank*, 1995 WL 170037 (D. Mass. 1995), the court also declined to follow *City Savings F.S.B.* on similar grounds. That court also failed to recognize the flaw in assuming the policy was an asset. Moreover, it actually disagreed with *City Savings F.S.B.* on the subject of constitutionality as well. The court held that forcing a declaratory relief claim through the administrative claims protocol placed a carrier at an undue peril of waiver. Therefore, requiring administration exhaustion violated due process. *Id.* at 6.

[50] *RTC v. Love*, 35 F.3d 972 (10th Cir. 1994); *National Union Fire Ins. Co. of Pittsburgh, PA v. City Savings, F.S.B.*, 38 F.3d 376 (3d Cir. 1994); *RTC v. Midwest Fed. Sav. Bank of Minot*, 36 F.3d 785 (9th Cir. 1993).

[51] *FDIC v. St. Paul Companies*, 634 F. Supp. 2d 1213, 1219 (D. Colo. 2008).

In FDIC v. St. Paul Companies,[52] the insurer appeared to argue, based on standard language in the "Notice/Proof" provisions of a financial institution bond, that only the named insured could recover on loss discovered prior to closure.[53] The question of whether the bank had actually discovered the loss prior to the takeover was close in that case. However, the court recognized the termination provisions of the bond were not designed to result in a *post hoc* forfeiture of bond proceeds the institution itself might have recovered.[54] In theory, such a retrospective forfeiture provision could be enforced. Thus, financial institution bonds are exempt from the prohibitions on so-called "*ipso facto* provisions" which extinguish contractual rights on insolvency or receivership.[55] There would be a serious question as to whether a bond with such evaporating coverage would be marketable. Moreover, a bond with such restrictive provisions might not be viewed by the bank regulatory authorities as sufficient to meet the mandatory insurance requirements of 12 CFR § 563.190(a). That provision requires federally insured institutions to maintain fidelity coverage.[56]

Nevertheless, new standing questions have arisen in the latest wave of failures. The use of bank holding companies was on the rise before 1999. However, since the enactment of the Graham Leach Blily Act also known as the Financial Modernization Act of 1999[57], most banks are

[52] 634 F. Supp. 2d 1213 (D. Colo. 2008).

[53] 634 F. Supp. 2d at 1219.

[54] *Id.*

[55] 18 U.S.C. § 1812(e)(13); *FDIC v. Aetna Cas. & Surety Co.*, 903 F.2d 1073, 1078 (6th Cir. 1990).

[56] Thus, even in the case of claims that are not contested, the investigation and adjustment of a complex bond claim can take months to years to complete. There would be no rational basis for a termination provision that allowed the surety to escape indemnification substantially after a loss was discovered and reported.

[57] Pub. L. 106-102; 113 Stat 1338.

owned by bank holding companies.[58] These new bank holding companies are independent entities. They may own other banks or non-bank assets as a result of the deconstruction of the so-called Glass-Steagall firewall prohibiting banks from engaging in bank and non-bank activities such as the sale of insurance and securities. As a result, some holding companies have continued to operate after a receivership. They sometimes seek bankruptcy protection to reorganize or seek an orderly liquidation of their assets.

This has created a situation in which the FDIC, bankruptcy trustees and bankruptcy creditors committees find themselves dueling for the same assets including issuance recoveries.[59]

The case of *Lubin v. Cincinnati Insurance Company*,[60] illustrates how the battle lines between the FDIC successors of the holding company may be drawn. *Lubin* arose out of the failure of Integrity Bank.[61] After the FDIC was appointed receiver both the FDIC and the trustee for Integrity Bank attempted to press for employee dishonesty coverage based on insider fraud that allegedly caused certain loan losses.[62] The trustee first sued to recover on the bond and the

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[58] According to the Federal Reserve Bank's "Partnership for Progress" Web site, 84% of all commercial banks and 75% of all community banks were owned by bank holding companies by the end of 2007.

[59] *E.g.*, *In re Bank United Financial Corp.*, 442 B.R. 49, 52-53 (2010); *Lubin v. Cincinnati Ins. Co.*, 2010 WL 5313754 (N.D. Ga. 2010). Cases have also dealt with disputes between shareholders of a bank holding company and the FDIC as to who had standing to pursue actions for derivative liability. *Broughton-Irving v. Saphir*, 2010 WL 4810605 (N.D. Ill. 2010); *Lubin v. Skow*, 2009 WlL 4641761 (N.D. Ga. 2009). The obvious ulterior objective of such disputes, not involving insurance coverage, has been to eliminate competing claims to available directors and officers liability coverage.

[60] 2010 WL 5313754 (N.D. Ga. 2010).

[61] *Id.,* at 1.

[62] *Id.,* at 2.

FDIC intervened. [63] To resolve the claims the bankruptcy court entertained cross-motions for dismissal and summary judgment.[64]

The FDIC had two significant obstacles to overcome in *Lubin*. First, as has become the norm with holding companies, the parent company was the first named insured.[65] The trustee contended that a provision designating the first named insured as the sole insured granted exclusive standing to the trustee to recover under the bond.[66] Complicating matters further for the FDIC, through an apparent underwriting error, Integrity Bank was inadvertently omitted from the subsidiary schedule.[67] Thus, having failed to name the bank as an insured, the trustee claimed that he alone had standing to sue. Allegedly, the holding company was not merely the named insured but the sole insured.[68]

In dealing first with the reformation issue, the court had no problem dispensing with the argument that, because the bank had not been named as an insured, the FDIC had no standing to sue for reformation.[69] All parties involved in the underwriting process including Cincinnati and the broker for the holding company agreed the omission of the bank was a mistake.[70] Relying on

[63] *Id.,* at 3.
[64] *Id.,* at 3-4.
[65] *Id.,* at 6.
[66] *Id.*.
[67] *Id.,* at 7-10.
[68] *Id.,* at 8.
[69] *Id.*, at 7-9.
[70] *Id.*

Georgia law and the circularity of the argument that an inadvertently omitted party lacked standing to seek reformation, the FDIC was found to have standing to sue for reformation.[71]

As to the question of which successor could rightfully pursue the employee dishonesty coverage claim, the court was clearly influenced by the outcome of earlier litigation between the FDIC and the trustee.[72] That action dealt with the issue of which party, as between the FDIC and the trustee, had superior standing to pursue breach of fiduciary duty claims based on the alleged mismanagement that led to the demise of the bank. Thus in *Lubin v. Skow*,[73] the Eleventh Circuit Court of Appeals was called upon to determine whether a breach of fiduciary duty claim brought on behalf of the holding company was an asset of the receivership estate which the FDIC alone could prosecute.[74] The FDIC intervened in an action against the officers and directors of the holding company and sought dismissal of the claim.[75] The agency relied on its exclusive and preemptive authority under 12 U.S.C. Section 1821(d)(2)(A) to pursue not only the pre-receivership claims of the bank but those of shareholders and creditors.[76] The trustee claimed that the mismanagement that led to the failure occurred at both the parent and subsidiary level. The trustee emphasized that the mismanagement had caused damage at the holding company level because the holding company itself took on inordinate debt to keep the bank afloat.[77] The

[71] *Id.,* at 10.

[72] *Lubin v. Skow*, 2009 WL 4641761 (N.D. Ga. 2009)

[73] 382 Fed.App'x. 866 (11th Cir. 2010).

[74] *Id.,* at 869-70.

[75] *Id.*

[76] *Id.,* at 870, *citing*, *Pareto v. FDIC*, 139 F.3d 696, 700 (9th Cir. 1998).

[77] *Id.,* at 871-72.

district court dismissed the trustee's case based on the FDIC's preemptive right to pursue shareholders' derivative claims.[78]

In affirming, the Court of Appeals held that the injury at the holding company level was not intrinsic but derivative of the underlying wrongful conduct in mismanaging the bank.[79] As such, the claim was exclusively that of the FDIC to pursue under FIRREA.[80]

Similarly, in *Lubin v. Cincinnati*, the trustee argued that its status as named insured rendered it the real party in interest in pursuing coverage.[81] However, because the receiver alone had the legal right and ability to pursue claims for losses suffered directly by the bank under FIRREA, the FDIC was deemed the real party in interest.[82]

The rulings of these federal courts harmonize with the general principle that only direct losses are covered by financial institution bonds.[83] When the insured institutions seek indemnification for coverage for loan losses on a joint and coordinated basis, as is the norm, the holding company is clearly entitled to direct payment. However, when the entities are in competition for the same recovery, the holding company is clearly more akin to a third party claimant or an insured who has suffered only an indirect loss in the form of diminution in assets as opposed to

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[78] *Id.,* at 872.

[79] *Id.,* at 872-73.

[80] *Id.*

[81] *Id.,* at 12.

[82] *Id.*

[83] *See*, *Vons v. Federal Ins. Co.*, 212 F.3d 489, 491 (9th Cir. 2000); *Auto Lenders Acceptance Corp. v. Gentili Ford, Inc.*, 816 A.2d 1068, 1073 (N.J. 2003).

loss of its owned property.[84] The loans are made by the bank and not the holding company. When the loan is not recoverable, its owned property is lost.

B. Liability Insurance Claims

As to third-party liability insurance, there is very limited precedent on the subject of the FDIC's standing to sue. The FDIC was a party to dozens of the numerous coverage actions dealing with directors and officers liability insurance during the prior bank failure crisis. Yet, as a general rule, third-party claimants have no standing to sue for coverage pending the resolution of the underlying liability claims.[85] Although certain states allow direct actions against insurers by statute, those claims are generally limited to personal injury or property damage claims under general liability policies.[86] Moreover, several courts have explicitly recognized that directors and officers liability policies do not afford third-party claimants or non-insured parties direct benefits or claims.[87] Moreover, most directors and officers liability policies generally have so-called "no-action" clauses which prohibit litigation against the insurer prior to the resolution of the underlying liability claim.[88]

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[84] *See*, *Cincinnati Ins. Co. v. Star Financial Bank*, 35 F.3d 1186, 1191 (7th Cir. 1994) (Bond does not cover indirect bookkeeping losses).

[85] Windt, 2 Insurance Claims and Disputes 5th, § 9:11, N. 1; *Ex Parte Lammon*, 688 So. 2d 836, 838, N. 2 (Ala. Civ.App. 1996).

[86] *See, First National Bank of Louisville v. Lustig*, 975 F.2d 1165, 1167 (5th Cir. 1992) (Direct action allege third-party claimant to sue under fidelity bond issued to savings and loan).

[87] *Matter of Vitek, Inc.*, 51 F.3d 530, 537-38 (5th Cir. 1995); *In re Minoco Group of Companies Ltd.*, 799 F.2d 517, 519 (9th Cir. 1986).

[88] *See*, *e.g.*, *Batsakis v. FDIC*, 670 F.Supp. 749, 759 (W.D. Mich. 1987); *Zaborac v. American Casualty Company of Reading, PA*, 663 F.Supp. 330, 333 (C.D. Ill. 1987).

The case of *Zaborac v. American Casualty Company of Redding, Pennsylvania*,[89] provides an example of a case where the FDIC was held to have no right to prosecute a third-party coverage action pending the resolution of the underlying case. In *Zaborac*, the FDIC and the insured directors attempted to pursue a declaratory relief action before the underlying shareholder derivative case to which the FDIC succeeded after the bank failed was resolved. The coverage action was dismissed based on both the no-action clause and the court's finding that there was no ripe case or controversy as of the time the declaratory relief action was first filed. Subsequently, after the directors and officers failed to respond to the complaint, a default judgment was entered.[90] At that point, an action challenging the application of the regulatory exclusion and the insured-versus-insured exclusion was allowed to proceed pursuant to a second post-judgment garnishment action.[91]

Similarly, in *Foster v. Mutual Fire Marine and Inland Insurance Company*,[92] the court held that a successor rehabilitator could not sue for a declaratory judgment under a directors and officers liability policy brought before an underlying liability case was brought and prosecuted.[93] The court held that, whereas it did not interpret the no-action clause in the policy as barring the coverage action, it also found there was no ripe case or controversy pending the resolution of a lawsuit against the directors and officers.[94]

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[89] 663 F.Supp. 330 (C.D. Ill. 1987).

[90] *FDIC v. Zaborac*, 773 F.Supp. 137, 138 (C.D. Ill. 1991).

[91] *Id.*

[92] 623 A.2d 928 (Pa. Commw. 1993).

[93] 623 A.2d at 930-31.

[94] *Id.; See also, FDIC v. Continental Casualty Co.*, 796 F.Supp. 1344, 1349 (D. Or. 1991) (FDIC's claim that it had "its own independent standing" to sue under a D&O policy rejected).

Notwithstanding potential standing questions, there were a number of "friendly" declaratory relief decisions during the prior bank failure crisis in which the FDIC participated as a party before the underlying liability case was resolved.[95] In some cases the FDIC intervened in pending coverage actions between the insurer and the directors and officers and the intervention appears never to have been challenged.[96] These decisions contain boilerplate jurisdictional recitals without a specific discussion as to why the FDIC was a party.[97]

The lack of comment and dispute over jurisdiction and standing in these cases likely reflects a mutual interest in resolving coverage issues, such as the effect of a regulatory exclusion, early on. Thus, the FDIC has historically been cognizant of the need to evaluate the collectibility of post-receivership FIRREA liability claims it prosecutes.[98]

Nevertheless, contemporary federal courts closely scrutinize jurisdictional, standing and case in controversy questions.[99] Several courts have challenged and rejected efforts by the FDIC to use intervention motions as a platform to create federal jurisdiction where there would be no original

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[95] *American Casualty Company of Reading, PA v. FDIC*, 39 F.3d 633, 636 (6th Cir. 1994) (Insurer intervened in underlying liability case); *St. Paul Fire & Marine Insurance Company v. FDIC*, 968 F.2d 695, 699 (8th Cir. 1992) (Liability insurer sued FDIC for declaratory relief in anticipation of third-party action against directors and officers which was later brought and reduced to stipulated judgment); *American Casualty Company of Reading, PA v. FDIC*, 16 F.3d 152, 153 (7th Cir. 1994) (Liability insurer sued FDIC for declaratory relief after filing of underlying state court action against officers and directors which was stayed pending outcome of coverage case).

[96] *E.g.*, *Fidelity & Deposit Company of Maryland v. Conner*, 973 F.2d 1236, 1240 (5th Cir. 1992); *Fidelity & Deposit Company of Maryland v. Zandstra*, 756 F.Supp. 429, 432-33 (N.D. Cal. 1990).

[97] *Id.*

[98] *See*, *Managing the Crisis, the FDIC and RTC Experience*, Chap. 11 (1998), Professional Liability Claims, p. 266 ("No claim is pursued by the FDIC unless it meets both requirements of a two-part test. First, the claim must be sound on its merits, and the receiver must be more than likely to succeed in any litigation necessary to collect the claim. Second, it must be *probable* that any necessary litigation will be cost-effective, considering liability insurance coverage and personal assets held by the defendants." (Emphasis added))

[99] *E.g.*, *Village of Oakwood v. State Bank & Trust Company*, 481 F.3d 364, 368-69 (7th Cir. 2007); *Broughton-Irving v. Saphir*, 2010 WL 4810605 (N.D. Ill. 2010).

jurisdiction.[100] Thus, even if all concerned stipulated to such "friendly" coverage actions in the past, there may be closer scrutiny by federal courts of standing and jurisdiction in the future.

One early trial court decision upheld the FDIC's right to intervene in a pending coverage action between the insurer and the directors and officers. In *Crosby v. St. Paul Fire & Marine Insurance Company*,[101] the court allowed the FDIC to intervene in a declaratory relief action. *Crosby* is one of the few published cases in which intervention by the FDIC was opposed. The court held that the intervention was appropriate under Rule 24 of the Rules of Federal Civil Procedure under Ninth Circuit standards.[102] The FDIC successfully argued that it had satisfied three basic requirements relating to its interest in intervening.[103] To intervene, the receiver had to establish an interest in the subject matter of the coverage action, that its interests might be prejudiced if intervention was denied and that the existing parties to the litigation would not adequately represent the agency's interest.[104]

The summary of the claim provided in the opinion raises questions as to whether the requirements for intervention were satisfied. The court held that there could be prejudice if the intervention were not allowed because insurance proceeds might be the only recoverable source of recovery.[105] Why the directors and officers themselves were not competent to protect their rights under the policy was never explained.

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[100] *Id.*

[101] 138 F.R.D. 570 (W.D. Wash. 1991).

[102] 138 F.R.D. at 572-73, *citing United States v. State of Oregon*, 893 F.2d 635 (9th Cir. 1988).

[103] *Id.*

[104] *Id.,* at 572.

[105] *Id.,* at 573.

Further, the discussion of the reasons the so-called "contingent interest rule" [106] should not apply was not persuasive The court cited authority holding that intervention may be allowed to avoid depletion and forfeiture of a recovery from a discrete identifiable fund that might otherwise be depleted.[107] The court never cited competing claims that might deplete the directors and officers liability policy. If there were such claims they were never described.

The court attempted to distinguish *Liberty Mutual Insurance Company v. Pacific Indemnity Company*[108], a case applying the contingent interest rule, on the grounds that the FDIC had a "substantial interest" as opposed to a mere contingent interest. *Liberty Mutual Insurance Company* held that a third-party liability claimant that has not in fact proved a liability claim against an insured holds a contingent interest as a matter of law.[109] The appellate cases discussed in the *Liberty Mutual* case held that a third party claimant does not have standing to intervene unless and until such a liability is established.[110] Any other interpretation of Rule 24 would be untenable in that a procedural rule would potentially modify state law which provides

[106] *In re HealthSouth Ins. Lit.*, 219 F.R.D. 688, 692 (N.D. Ala. 2004); *Liberty Mutual Insurance Company v. Treesdale Inc.*, 419 F.3d 216, 223-24 (3d Cir. 2005).

[107] *Id.,* at 573, *citing National Union Fire Insurance Company v. Continental Illinois Corp.*, 113 F.R.D. 532, 535 (N.D. Ill. 1986).

[108] 76 F.R.D. 656, 658 (W.D. Pa. 1977).

[109] *Id.,* at 658.

[110] *Liberty Mutual*, *supra*, 138 F.R.D. at 572-73, *citing J&N Logging Company v. Rockwood Insurance Company*, 848 F.2d 1438, 1440 (8th Cir. 1988). *See also*, *Liberty Mutual Insurance Company v. Teasdale Inc.*, 419 F.3d 216, 223-24 (3d Cir. 2005) (Third parties have no right to pursue coverage actions until underlying personal injury actions are resolved).

that a third-party claimant does not have standing to sue a liability carrier while its claim is still contingent and unliquidated.[111]

Such an application of Rule 24 would conflict with substantive state insurance coverage law in a second way. Directors and officers liability policies generally contain no-action clauses. If there was a no-action clause in the policy construed in *Crosby,* the provision was never discussed by the court. However, cases interpreting and applying such provisions have held that they bar direct claims by the FDIC for declaratory judgment.[112]

There are ways for the FDIC to participate in coverage litigation in conformity with state law. A no-action clause may be waived. Moreover, a claim may be pursued under an assignment of rights with or without the cooperation of the insurer.[113] In any event, the *Crosby* decision is doubtful precedent in light of higher authority recognizing claimants with unliquidated liability claims cannot intervene in coverage actions between a defendant and a third-party liability carrier.

A second argument in support of successor standing appears reasonable at first glance. In *FSLIC v. Oldenburg*,[114] the court held that, as a successor, the FSLIC had standing to seek declaratory

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[111] *See*, *e.g.*, *American Casualty Co. v. Glaskin*, 805 F.Supp. 866, 870 (D. Colo. 1992) (RTC as receiver did not have right to bring coverage claim as alleged third-party beneficiary of liability policy).

[112] *Vatsakis v. FDIC*, 670 F.Supp. 749, 759 (W.D. Mich. 1987); *Zaborac v. American Casualty Company of Reading, PA*, 663 F.Supp. 330, 333 (C.D. Ill. 1987).

[113] Windt, 2 Insurance Claims in Disputes, 5th §§ 9-15-16 (W. 2011); *see*, *e.g.*, *Maneikis v. St. Paul Insurance Company of Illinois*, 655 F.2d 818, 826 (7th Cir. 1981); *Biltmore Associates LLC v. Twin City Fire Insurance Company*, 572 F.3d 663, 667 (9th Cir. 2009).

[114] 671 F.Supp. 720 (D. Utah 1987) (Applying New Mexico law).

judgment as to liability coverage in lieu of the failed savings institution.[115] The court determined the directors and officers were third-party beneficiaries of a liability insurance policy and that the savings institution, as the primary contracting party had standing to bring a coverage action.[116] As such, the court concluded the FSLIC had standing to sue to establish the coverage for the directors and officers.[117]

Similarly, in *Wedtech Corp v. Federal Insurance Co.*,[118] the *Oldenburg* decision was cited for the proposition that a "promisee" under a contract, namely the insolvent business, had primary standing to sue under principles of privity of contract.[119] As in *Oldenburg*, the court relied on the doctrine that a "promisee" may always sue to enforce rights bargained for the benefit of third parties.[120]

In fact, these decisions are flawed in two respects. First, under contract law, the "promisee" is not the party that cuts the premium check. A promisee is the party the contract identifies as entitled to directly enforce a given promise or covenant.[121] If the promisee was determined on a "follow the money" basis, in most cases the holding company would be considered the sole promisee. Both the bank and the directors and officers would be considered subordinate third-

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[115] *Id.*, at 725.

[116] *Id.*

[117] *Id.*

[118] 740 F.Supp. 214, 220 (S.D. N.Y. 1990).

[119] *Id.*

[120] *Id.*, at 219.

[121] *E.g., United Steelworker of America, AFL-CIO-CLC v. Rawson*, 495 U.S. 362, 363 (1990); *Lovell Land, Inc. v. State Hwy Admin.*, 952 A.2d 414, 429 (Md. App. 2008).

party beneficiaries. Rather, the party to whom contractual obligation is expressly made is not a mere beneficiary but the obligee with primary standing to sue for breach of contract.[122]

Second, the characterization of the bank as the primary beneficiary and the directors and officers as mere third-party beneficiaries cannot be reconciled with standard policy language.[123]

A directors and officers liability policy is not an ordinary contract executed by two principal contracting parties. Thus, in consideration of the premium and the representations and warranties made separately in the application the policy is issued.[124] Under a standard policy the "insured persons" or insureds are the directors and officers.[125] It is well established that only the named insured under a contract has standing to sue for policy benefits unless a non-insured can establish the policy was issued for his sole benefit.[126] To strengthen this principle many policies have so-called "sole benefit" provisions.[127] Some states have enacted the sole benefit provisions by statute.[128]

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[122] *Id.*

[123] Knepper and Bailey, *Liability of Corporate Officers and Directors*, (8th Ed. Matthew Bender) § 23.02, (Overview of the D&O Policy, p. 23-3 – 4).

[124] *Id.*, at § 23.07, *citing, National Union Fire Insurance Co. of Pittsburgh, PA v. Xerox Corp*., 792 N.Y.S.2d 772, 773-4 (2004), *aff'd*, 807 N.Y.S.2d 344 (2006) (Describing mechanics of application process leading up to issuance).

[125] *Matter of Vitek, supra*, 51 F.3d at 534-35; *In re Downey Financial Corp*., 428 B.R. 595, 600 (Bkrtcy. Del. 2010).

[126] *Maxon v. Camden Fire Insurance Ass'n*, 389 S.E.2d 743, 745 (1990); *McDivitt v. Pymatuning Mutual Fire Insurance Co.*, 303 Pa.Super. 130, 449 A.2d 612, 614-15 (1982) (quoting *Forsyth County v. Plemmons*, 2 N.C.App. 373, 375, 163 S.E.2d 97, 99 (1968); S*ee generally,* Couch § 242:32, Nonparty to Insurance Contract, Generally (2011).

[127] *E.g., In re Downey Financial Corp.*, 428 B.R. at 600.

[128] *E.g., Executive Risk Indemnity, Inc. v. Charleston Area Medical Center, Inc.*, 681 F. Supp. 2d 694, 721 (S.D. W.Va. 2009).

The source of confusion in the case of directors and officers policies may be that the typical dual form contains *both* an insurance contract for the sole benefit of the directors and officers known as the "direct" form, as well as an indemnification or reimbursement form.[129] The institution qualifies for "indemnification" or "reimbursement" coverage. Under that agreement, the institution itself is entitled to be reimbursed for insured defense costs and other loss it might otherwise be required to indemnify under corporate law.[130] Undoubtedly, the corporation and the insured directors and officers are both intended beneficiaries of that form of liability coverage.[131]

However, after a receivership or other insolvency, the so-called "direct" form applies to insure defense costs and other loss the institution cannot pay. This serves as insolvency insurance after a receivership. The direct form applies, because the bank is no longer in a position to pay any claim by any creditor. The institution is not even part of the insurance equation as to the direct form and plainly not a beneficiary.[132] Neither the bank nor any successor has any right or interest as to direct coverage.[133]

Further, in a coverage action arising out of a FIRREA action, the FDIC does not approach the controversy as a *successor* seeking to protect the officers from third party claims brought by

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[129] Knepper and Bailey, *supra*, *Liability of Corporate Officers and Directors*, § 23.02 pp. 23-3–4.

[130] *Id.*, *see also, In re Minoco Group of Companies, Inc.*, 799 F.2d 517, 519 (9th Cir. 1986) (Explaining manner in which liability insurance may still apply to indemnify contingent unliquidated liability claims made by parties *other than debtor corporation* after bankruptcy).

[131] *In re Minoco, supra*, 799 F.2d at 519; *Bird v. Penn Central Co.*, 345 F.Supp. 255, 261 (E.D. Pa. 1971). In addition, the corporation obviously intended the beneficiary of "entity coverages" that are now popular in D&O policies. *In re Matter of Vitek, supra*, 51 F.3d at 535.

[132] *In re Vitek*, 51 F.3d at 533-35; *In re Downey Financial, supra*, 428 B.R. at 603; *In re Allied Digital Technologies Corp.*, 306 B.R. 505, 512-513 (Bkrtcy. Del. 2004).

[133] *Id.*

shareholders or others through insurance. It approaches the dispute as the *adverse claimant*. Thus, in one published decision, the FDIC attempted to avoid the prohibition against adverse parties intervening in coverage actions.[134] The receiver claimed it might fund both sides of the case and pay the defense costs of the officers and directors in the breach of fiduciary cases it was prosecuting.[135] The court granted summary judgment noting that such a circular indemnification was legally impossible and factually unsupported.[136]

In conclusion, the FDIC has no right to intervene in litigation over the availability of coverage for liability claims it prosecutes as the plaintiff unless and until it prevails.[137] Any such intervention before the liability claim is resolved is strictly permissive and consensual as among the insured defendants, the insurer and the receiver.

IV. RESCISSION

A. The Secret Agreement Defense

The FDIC may inherit the unfavorable consequences of misrepresentations made by former management in acquiring insurance policies. Thus, material application errors may result in the rescission of a financial institution bond or directors and officers liability policy after the receiver

[134] *FDIC v. Continental Casualty Co.*, 796 F.Supp. 1344, 1349 (D. Or. 1991).

[135] *Id.*

[136] *Id.*

[137] *Id.*; *American Casualty Co. v. Glaskin*, 805 F.Supp. 866, 870 (D. Colo. 1992).

is appointed.[138] However, FIRREA has been found to preempt rescission rights that would otherwise lie under state law in certain limited circumstances.

Under 12 U.S.C. section 1823(e), the receiver may not be subject to defenses based on facts that are not recorded in the books and records of the institution.[139] Section 1823(e) represents the codification of the so-called *D'Oench Duhme* doctrine.[140] The doctrine is similar to the so-called strong-arm powers afforded to bankruptcy trustees under section 11 U.S.C. 544.[141] A bankruptcy trustee takes the assets of a debtor as they appear as a matter of record title and free and clear of unrecorded liens and encumbrances.[142] Similarly, under section 1823(e), the receiver is entitled to take the assets of the institution free and clear of "secret agreements," that is, those that cannot be readily discovered from the books and records of the bank.[143]

Since the *D'Oench* doctrine was first raised successfully by the FDIC in *FDIC v. Oldenburg,*[144] commentators have referred to a "split" of authority as to whether a defense can be legitimately raised.[145] In fact, three different tests have emerged in three federal circuits that have considered how the statute applies to rescission actions.

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[138] *E.g.*, *FDIC v. Aetna Casualty & Surety Co.*, 947 F.2d 196, 208 (6th Cir. 1991) (Fidelity bond); *FDIC v. Great American Insurance Company*, 607 F.3d 288, 296 (2d Cir. 2010) (Fidelity bond); *National Union Fire Insurance Company of Pittsburgh, PA v. FDIC*, 837 SW 2d 373, 381-82 (Tenn. 1992) (Directors and officers liability policy).

[139] *FDIC v. Oldenburg*, 34 F.3d 1529, 1550 (10th Cir. 1994).

[140] *Id.*

[141] *In re Halabi*, 184 F.3d 1335, 1337 (11th Cir. 1999)

[142] *Id.*

[143] *Oldenburg*, 34 F.3d at 1550.

[144] 34 F.3d 1529 (10th Cir. 1994).

[145] *E.g.*, Young, *Misrepresentations in the Financial Institution Bond Application*, II Fidelity Law Association Journal (November 1996), p. 41.

Oldenburg applied a two-part test to the question of whether false information submitted in a bond application could support a rescission defense in a suit to enforce the bond brought by the FDIC after closure.[146] First, the *Oldenburg* court considered whether the bond was an "agreement" and thus an asset falling within the scope of section 1823(e).[147] The *Oldenburg* court found unpersuasive arguments that the term "agreement" in the statute applied narrowly to loans, security agreements, and other agreements related to extensions of credit to which the doctrine had been traditionally applied prior to the enactment of FIRREA.[148] The court acknowledged that the legislative history was wholly unclear as to how broadly section 1823(e) was to be construed.[149] However, the Court of Appeals noted that there was no express limitation indicating an intent to eliminate insurance policies from the scope of the statute and that bonds had traditionally been considered "assets" of the FDIC as receiver.[150]

As to the question of whether the misrepresentations would allow the insurer to set up a rescission defense against the FDIC, the court noted that the bond application was not part of the bond itself.[151] It held further that, even if the application had been encompassed within the bond, it did not meet the strict requirements of Section 1823(e).[152] This included the requirements that any agreement impairing the rights of the institution be in writing, approved by the board of directors, and continuously on file in the records of the institution.[153]

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[146] 34 F.3d at 1551.

[147] *Id.*

[148] *Id.,* at 1552-53.

[149] *Id.,* at 1552, N. 29.

[150] *Id.,* at 1552-53.

[151] *Id.,* at 1551.

[152] *Id.*

[153] *Id.,* at 1550, *citing* 12 U.S.C. § 1823(e).

In *FDIC v. Aetna Casualty & Surety Company*, [154] the Sixth Circuit Court of Appeals found that a financial institution bond did not fall within the scope of section 1823(e).[155] The court conducted an extensive evaluation of the types of cases that fell within the *D'Oench* doctrine prior to the enactment of Section 1823(e).[156] The court discussed the fact that the *D'Oench* doctrine had consistently been applied to loans, security agreements, guarantees and the like.[157] As in the case of a bankruptcy trustee's strong-arm powers, the intent was to provide the agency with clear title and holder-in-due-course status to the bank's loan portfolio and security interests.[158]

The court observed that a financial institution bond is wholly dissimilar to the bulk of an institution's loan portfolio and other assets in that it is a "bilateral agreement."[159] Unlike a simple note, the financial institution bond establishes a series of mutual obligations as between the insurer and the insured including the requirement to submit a truthful bond application.[160] The court held that, to interpret the statute to cover such agreements would be equivalent to engrafting "a holder-in-due-course doctrine onto insurance law".[161] The court found no basis in

[154] 947 F.2d 196 (6th Cir. 1991).

[155] 947 F.2d at 206-07.

[156] *Id.,* at 201-07.

[157] *Id.*

[158] *Id.*

[159] *Id.*

[160] *Id.,* at 206-07.

[161] *Id.,* at 207.

the legislative history of the statute to federalize state insurance law after a receivership in that fashion.[162]

The *Aetna Casualty & Surety* court also provided an additional rationale. It held that, even if the *D'Oench* doctrine applied, the so-called "secret agreement" criteria could not be met. It noted that the bond application was in fact included in the bank's records.[163] However, the court conceded that the bond itself contained no warranty that the contract would be void if the application proved false.[164] Thus, the *Aetna Casualty & Surety* court ruled as it did primarily because it concluded bonds do not fall within the scope of Section 1823(e).

The Second Circuit Court of Appeals also held that the rescission defense was available to a financial institution bond insurer in *Federal Deposit Insurance Corporation v. Great American Insurance Company*.[165] The court in *Great American Insurance* disagreed with the Sixth Circuit Court of Appeals on the threshold question of whether the bond was an asset which fell within the scope of Section 1823(e).[166] The court agreed with *Oldenburg's* finding that a bond is an agreement falling within the scope of Section 1823(e).[167] Notwithstanding that the *D'Oench* doctrine had typically been applied primarily to loans, the court could find nothing in the plain language of the statute to limit its coverage to loan, security and similar agreements.[168]

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[162] *Id.,* at 203-04.

[163] *Id.,* at 202.

[164] *Id.,* at 206-07.

[165] 607 F.3d 288, 293-95 (2d Cir. 2010).

[166] *Id.,* at 293.

[167] *Id.*

[168] *Id.*

The court nevertheless ruled that the rescission defense was available to the insurer in that case. Thus, there was a warranty within bond itself that the application was accurate.[169] This provision in the Great American bond was substantially identical to the language in the first clause of general agreement D of the current 2004 version of Standard Form No. 24 which states:

> REPRESENTATION OF INSURED
>
> D. The insured represents that the information furnished in the application for this bond is complete, true and correct. Such application constitutes part of this bond.
>
> Any intentional misrepresentation, omission, concealment or incorrect statement of a material fact, in the application or otherwise, shall be grounds for the rescission of the bond.[170]

Now that the standard financial institution bond contains an express incorporation of the warranties in the application, one commentator has concluded that the ruling of *Oldenburg* should not be applied in any case.[171] With the warranty now so prominent within the bond, certainly the policy rationale behind the statute in the *Oldenburg* decision does not fit the facts of a typical rescission case.[172] However, *Oldenburg* also applied a rigid approach to all elements of the four-part test for setting aside a "secret agreement". The court held that express board

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[169] 607 F.3d at 294.

[170] *Id.,* at 294; Financial Institution Bond, Standard Form 24, General Agreement (D) (revised April 2004), reprinted in Standard Forms of the Surety Ass'n of America (Surety Ass'n of America) (hereinafter "2004 Bond").

[171] Keeley, *"Superpowers" of the Federal Regulators: The Subprime Mortgage Crisis and Bond Claim Issues Arising From Takeover by the FDIC*, XVI Fidelity Law Journal (October 2010), p. 67-68.

[172] *See*, *e.g.*, *FDIC v. Moskowitz*, 946 F.Supp. 322, 325, 329-30 (D. N.J. 1996) (Case upholding rescission under 1986 warranty language and applying state law).

approval was required as to all agreements falling within the statute.[173] A board resolution approving every bond or other policy application is still not the norm today. As one court put it, if all elements of the statute had to be satisfied as to insurance applications, such a rule would be "giving the FDIC the ability to transmute lead into gold."[174]

One court declined to recognize a *D'Oench* defense in a context similar to that of the *Great American Insurance* case.[175] In *National Union Fire Insurance Company of Pittsburgh v. FDIC*,[176] the Supreme Court of Tennessee held that Section 1823(e) did not bar the assertion of a rescission defense in a situation where the policy explicitly referred to the warranties made in the application.[177] As in *Great American Insurance*, the court did not conduct a point-by-point evaluation of whether the four prongs of Section 1823(e) had been met. Rather, it noted that, with the warranties as to the truthfulness of the application set forth within the policy itself, there simply could be no credible claim that such limitations on coverage constituted a "secret agreement."[178]

However, the court in *National Union Fire Insurance* missed a critical point that distinguishes third-party insurance policies from first-party policies such as bonds. The court held a directors and officers liability policy was an asset merely because the warranties respecting application

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[173] 34 F.3d at 1554.

[174] *National Union Fire Insurance Company of Pittsburgh, PA v. Dominguez,* 873 S.W.2d 373, 382 (Tenn. 1994).

[175] *Id.*

[176] 873 S.W.2d 373 (Tenn. 1992).

[177] *Id.,* at 381.

[178] *Id.,* at 381-82.

fraud might tend to diminish or defeat the FDIC's interest in the asset.[179] As discussed in the previous section, the assumption that the FDIC has an established interest in a third-party liability in its capacity as an adverse claimant is not supported under state law and federal courts have recognized that fact.[180]

The interpretation of Section 1823(e) by the *Oldenburg* court also implicitly conflicts with the general principle that the receiver's rights are derivative of those of the failed bank. As one commentator noted in an extensive article on rescission of financial institution bonds, in most states rescission is authorized under common law principles of *uberrimae fide* and by statute.[181] Thus, the right to rescind under the terms of the policy are usually supplemental to that provided for under state law. Utah, for example, prohibits application fraud under statutes which were enacted well before the *Oldenburg* case was decided.[182] Thus, to the extent the *D'Oench* doctrine is raised in the future, the principle in *Oldenburg* explicitly acknowledged, that FIRREA is not intended to supplant state law with federal common law, should be more carefully studied.[183] Section 1823(e) voids secret agreements. It does not purport to modify rescission

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[179] *Id.,* at 381.

[180] *See*, Section III, *supra*, Notes 87 to 94.

[181] Young, II Fidelity Law Association Journal, *supra*, pp. 22-40.

[182] Utah Code Ann. section 31 A-21-105 (1994). See, *Home Savings and Loan v. Aetna Cas. & Surety Co.*, 817 P.2d 341, 358 (Utah 1991) (Applying predecessor version of existing statute). Thus, *Oldenburg* was decided under Utah law and recognized that state law would control construction of the policy. 34 F.3d at 1537.

[183] Thus, *Oldenburg* acknowledged the general principle that FIRREA should not be read to preempt state law unless there is some important federal policy at stake. 34 F.3d at 1538, *citing*, *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 87 (1994). The failure of the Tenth Circuit Court of Appeals to consider that the right to rescind under Utah law was not merely the subject of private agreement but independently supported by state statute constitutes a significant flaw in the decision given the Supreme Court's ruling in the *O'Melveny* case.

rights that would otherwise exist under state law as to policies that conform to the requirements of state statutes.[184]

B. Standards for Rescission Under Financial Institution Bonds

The failure to disclose the circumstances leading to a closure may itself support rescission. An issue which arises after a receivership is the question of whether the circumstances leading up to closure were adequately disclosed within applications submitted during the time the institution was struggling. It is common for a standard bond application as to whether any recent regulatory criticisms remain unresolved. In *FDIC v. Moskowitz*,[185] the FDIC unsuccessfully attempted to challenge an application question which stated:

> Was there any criticism of your operations in either the last State or Federal examination?
>
> If "Yes", explain.[186]

[184] *E.g.*, *Moskowitz*, *supra*, 946 F.Supp. at 325, 329-30 (FDIC did not raise *D'Oench* defense under bond with 1986 version of Form 24 containing warranty language). Some states such as Illinois in fact require incorporation and attachment of the application. *National Union Fire Ins. Co. v. Continental Illinois Corp.*, 685 F.Supp. 781, 788 (N.D. Ill. 1987). The net effect of *Oldenburg* would be to federalize the rigid statutes of states like Illinois in states that do not impose such requirements.

[185] 946 F.Supp. 322 (D. N.J. 1996).

[186] 946 F.Supp. at 323.

The bank answered "No" to the question when in fact there was a long history of criticisms leading up to closure.[187] The FDIC challenged the question as being so inherently subjective as to be ambiguous and thus unenforceable.[188]

The district court agreed that the question was facially subjective. The court disagreed that the subjective component made the question too ambiguous to apply in all circumstances.[189] The court observed:

> Under certain circumstances, however, a response to a subjective question may be objectively false.

Given the repeated and detailed criticisms that led to the failure in *Moskowitz*, the court held that there was no reasonable question of fact as to whether the operations of the institution had been criticized.[190] Similarly, the elements of materiality and reliance were held established.[191] Materiality was established based on the very fact that the question was standard and asked as a matter of course.[192] An uncontroverted affidavit from the underwriter averred that she would not have issued the bond had she known of these regulatory problems. This supported favorable findings in favor of the carrier on the elements of both materiality and reliance.[193]

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[187] *Id.,* at 325-27.

[188] *Id.,* at 329.

[189] *Id.,* at 330.

[190] *Id.*

[191] *Id.,* at 330-32.

[192] *Id.,* at 331-32.

[193] *Id.*

In prevailing on summary judgment, the carrier also had to show the misrepresentation was knowing under New Jersey law.[194] The case was decided under the 1986 version of Form 24 which did not expressly contain the term "intentional misrepresentation" in the second paragraph of General Agreement D.[195] The court again found the FDIC failed to raise an issue of fact in light of undisputed documentary evidence that the full board was aware of the key regulatory directives and criticisms.[196]

As noted, the requirement under the 2004 version of General Agreement D, of establishing an "intentional" misrepresentation, conforms with the statutory and common law requirements of many states.[197] The 2004 revision ensures uniformity in applying the higher standard in all states in which the bond is issued. In addition, the current warranty language may be construed to eliminate the requirement of showing of materiality.[198]

However, for those insurers that continue to use the 1986 version of the Bond, a lesser showing of scienter could suffice to support rescission.[199] Thus, in *National Bank of Andover v. Kansas Bankers Surety Company*,[200] the court of appeals reversed a trial court ruling that the surety had

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[194] *Id.,* at 329-30.

[195] *Id.,* at 325.

[196] *Id.,* at 330-31.

[197] Windt, 1 Insurance Claims and Disputes 5th (West 2011), section 2:26, N. 11, 15 and 18 (Collecting cases in states applying intentional fraud standard).

[198] *E.g.*, *Vlastos v. Sumitomo Marine and Fire Ins. Co. (Europe) Ltd.*, 707 F.2d 775, 777 (3d Cir. 1983). *See generally*, *Young*, *supra*, pp. 23-24 (Discussing potential advantages of using warranty language in pursuing rescission).

[199] *See* Windt, *supra*, section 2:26, N. 11 (Collecting cases allowing rescission based on innocent misrepresentation).

[200] 225 P.3d 707 (Kan. 2010).

to prove intentional fraud in the application process to rescind the bond.[201] The Supreme Court of Kansas upheld this ruling. The bond application had language that was very similar to the 1986 version of Form 24 in containing both warranty and simple misrepresentation language:

> The insured represents that the information furnished in this application is complete, true and correct. Any misrepresentation, omission, concealment or any incorrect statement of a material fact, in this application or otherwise, shall be grounds for the rescission of any bond issued or renewed in reliance upon such information."[202]

The Supreme Court disagreed that an intentional fraud standard based on common law elements of fraud and rescission should be read into the bond when the bond itself did not adopt that standard.[203] The Court observed that rescission for negligent misrepresentation or omission was actionable under Kansas law.[204] The Court noted that the bond was a contract between "two sophisticated commercial entities."[205] Provisions that allow for rescission based on unintentional misrepresentations do not violate public policy and should be enforced as written.[206]

As such, the use of the current version of Form 24 could result in the insurer self-imposing a higher level of scienter to support rescission than might otherwise be required under state law.

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[201] 225 P.3d at 716-18.

[202] *Id.,* at 712.

[203] *Id.,* at 715-17.

[204] *Id., citing Scott v. National Reserve Life Insurance Company*, 143 Kansas 678, 680 (1936).

[205] *Id.,* at 718.

[206] *Id.*

C. Severability Provisions in Directors and Officers Liability Policies

In the case of third-party insurance, variations in policy language raise different issues on the availability of the rescission defense. Rescission can create harsh consequences for officers and directors who were not involved in application inaccuracies and have no knowledge that it occurred. The problem can be particularly poignant in the case of outside directors. For example, an outside director might not know of a threatened liability claim because it failed to reach the level of materiality for presentment to the full board at the time it was first made.

As a general rule, when there is a right to rescind, the rescission is effective against all insureds including those not involved in the misrepresentation.[207] To avoid this harsh result, so-called severability clauses have been introduced to directors and officers and professional liability policies.[208] An "any insured" severability provision was construed in the directors and officers policy at issue in *Wedtech Corp. v. Federal Insurance Company*[209]:

> The written application for coverage shall be construed as a separate application for coverage by each of the Insured Persons. With respect to the declarations and statements contained in such written application for coverage, no statement in the application or knowledge possessed by any Insured Person(s) shall be imputed to any other Insured Person(s) for the purpose of determining the availability of coverage with respect to claims made against any Insured Person(s) whether or not the Insured Organization grants indemnification.

[207] *TIG Insurance Company of Michigan v. Homestore Inc.*, 137 Cal.App.4th 749, 758-59 (2006).

[208] *Id.*

[209] 740 F.Supp. 214, 217 (S.D. N.Y. 1990).

In *Wedtech*, the rescission defense was based on the failure to disclose a government investigation which led to a series of lawsuits.[210] However, one director, Cavazos, joined the board of directors after the application had already been submitted. He also rejoined the company after it filed bankruptcy.

Federal attempted to rely on common law principles that a contract may be void *ab initio* under New York law based on application fraud.[211] Federal reasoned that, since none of the actual board members who were associated with the company at the time of the application was filed could rely upon the severability provisions, the policy should be cancelled in its entirety. The court disagreed, relying upon a similar Massachusetts case.[212] The court held that the severability provisions should be applied on an insured-by-insured basis.[213] A final ruling on the question of whether the late appointment of Cavazos to the board could revive a policy that might have been voided before he joined the organization was ultimately deferred by the court as raising an issue of fact.[214]

The case of *In re HealthSouth Corporation Insurance Litigation*[215] illustrates the risks associated with a broad form "any insured" severability provision. There, the severability provision provided:

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[210] *Id.,* at 216-17.

[211] *Id.,* at 216.

[212] *Shapiro v. American Home Assurance Company* , 616 F.Supp. 900, 903-05 (D. Mass. 1984).

[213] *Id.,* at 219

[214] *Id.*

[215] 308 F. Supp. 2d 1253 (N.D. Ala. 2004).

> Such written application(s) for coverage shall be construed as a separate application for coverage by each of the **Insured Persons**. With respect to the declarations and statements contained in such written application(s) for coverage, no statement in the application or knowledge possessed by any **Insured Person** shall be imputed to any other **Insured Person** for the purpose of determining if coverage is available.[216]

The facts of the case were not uncommon in that the fraud went beyond the four corners of the application. Thus, the carriers contended that they had been subject to a broader scheme of fraud in the inducement than that represented by misstatements in the application.[217] They urged that the legal right to rescind under ordinary common law principles for the overall fraud in the procurement of the policies should not be limited by severability language of the policies.[218] Those provisions, the insurers argued, only governed misrepresentations in the application.[219] The fraud committed by the corporation outside of the application should be imputed to all insured officers and directors.[220]

The court rejected the argument. It held that the intent of the severability clause was to completely insulate the insureds from imputation of all forms of fraud in which individual insureds were not personally involved.[221] Thus, the severability clause was held to govern the right to rescind based not merely on application fraud, but the right to rescind generally.

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[216] 308 F. Supp. 2d at 1261.

[217] *Id.,* at 1281-85.

[218] *Id.,* at 1283-84.

[219] *Id.*

[220] *Id.*

[221] *Id.,* at 1286-88.

In order to maintain the right to rescind in cases of clear and deliberate procurement of a policy under false pretenses, many carriers have developed a hybrid severability clause. One such provision was construed in the case of *Cutter and Buck Inc. v. Genesis Insurance Company.*[222] The clause in *Cutter and Buck* created an exception to the severability provisions.[223] In particular, the carrier had the right to rescind in the case of misrepresentations made with an actual intent to deceive and/or those which might materially affect the acceptance of the risk.[224] Instead of granting blanket severability to those who did not sign the application, the application allowed for rescission without qualification if the information that was concealed and misrepresented was "known to the person or persons who signed the Application."[225] Against an argument that the provision was ambiguous, the court described the objective of the exception to severability as follows:

> This clearly implies that when the signor knows that there are misrepresentations in the application materials, that knowledge is imputed to all other directors or officers. The result is that innocent directors or officers retain coverage unless the application's signor knows of a misrepresentation within the application, in which case even innocent directors and officers lose coverage.[226]

There are a number of good reasons for such modified severability provisions. First, allowing the acquisition of insurance based on deliberate misrepresentation and concealment raises public policy problems. Specifically, it contravenes the public policy against purchasing insurance for a

[222] 306 F. Supp. 2d 988 (W.D. Wash. 2004).

[223] *Id.,* at 1011.

[224] *Id.*

[225] *Id.*

[226] *Id.,* at 1012.

known loss.[227] Second, severability provisions are designed to preserve the benefit of the bargain for innocent insureds that may lose coverage through the negligence and inattentiveness of the corporate officer that prepares the application. To apply severability in the case of deliberate misrepresentations, in effect, provides the innocent insured the unfair windfall of insurance coverage that would have never been placed but for knowing fraud. There is a reasonable argument that, even in the case of a broad form severability provision, such as that found in the *Healthsouth Corporation*, the limitation in the clause found in *Cutter and Buck* should be implied as a matter of sound public policy.

V. TERMINATION PROVISIONS

The termination provisions of financial institution bonds and directors and officers liability policies are similar in that both provide for the automatic lapse of coverage at the time of closure. Coverage under the 2004 bond terminates "immediately upon the taking over of the insured by a receiver or other liquidator or by State or Federal officials."[228] A typical directors and officers liability policy specifies that coverage shall cease when the bank "has ceased to engage in the active banking business or to accept deposits."[229]

A. Automatic Termination of a Financial Institution Bond

[227] *See generally*, Windt, *supra*, § 3:18.

[228] 2004 Bond, Conditions and Limitations, § 12, Termination or Cancellation.

[229] *E.g., American Casualty Co. of Reading, PA v. FDIC*, 33 F.3d 62 (10th Cir. 1994); *American Casualty Co. of Reading v. FDIC*, 821 F.Supp.655, 661 (W.D. Okla. 1993).

The earliest efforts to challenge the automatic termination provisions in financial institution bonds were based on alleged ambiguities in the policy language.[230] As in the case of the current version of Section 12, the bond in *Sharp v. FSLIC*[231] provided for automatic termination in the event of a takeover.[232] The FDIC relied on a notice provision applicable to cancellations by the bank or the carrier. The agency argued that the notice provision either modified the termination provision or alternatively, created an ambiguity as to the effective date of termination. In particular, there was a ten-day hold on cancellation until receipt of notice of the termination by the Federal Home Loan Bank of which the savings institution was a member.[233]

The Fifth Circuit Court of Appeals held that said qualification only applied to voluntary terminations by the parties and not to the automatic termination provision.[234] The court noted that the agency was effectively attempting to modify the bond to mirror the termination provisions of an earlier version of the standard form used for savings institutions.[235] The court carefully scrutinized the drafting history. It found that the intention to eliminate a notice provision with respect to takeovers of the institution was clear from the drafting history. The court ruled that the language implementing that change was unambiguous.[236]

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[230] *E.g., Sharp v. FSLIC*, 858 F.2d 1042, 1047-48 (5th Cir. 1988); *United States Fire Insurance Co. v. FDIC*, 981 F.2d 850, 851-52 (5th Cir. 1993).

[231] 858 F.2d 1042 (5th Cir. 1988).

[232] *Id.* at 1045.

[233] *Id.*

[234] *Id.,* at 1046-47.

[235] *Id.*

[236] *Id.*

The court observed that automatic termination was entirely reasonable under the circumstances of a takeover.[237] Insuring the institution after a takeover represented a materially different risk, because the officials who had purchased the bond to ensure their own honesty were no longer in control of the institution. Thus, to continue coverage after a receivership would substantially alter the character of the risk covered by the policy.[238]

In *Mutual Security Life Insurance Co. V. Fidelity & Deposit of Maryland*,[239] a successor liquidator argued both that an automatic termination provision and a fidelity bond violated public policy and a statute which required 30 days notice of cancellation or termination of a policy. The court rejected both arguments.[240] As to the cancellation argument, the court held that the cancellation statute covered only a discretionary decision to cancel coverage.[241] Cancellation provisions have no application when a policy lapses in the event of certain defined events such as a takeover.[242]

Because takeover is not defined, several early cases dealt with disputes as to the precise date of automatic termination. In *United States Fire Insurance Co. v. FDIC*,[243] the FDIC argued that only an involuntary assumption of control by regulators met the definition of a "takeover."[244] The bank in that case had entered into a voluntary supervisory agreement with the state savings

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[237] *Id.*, at 1045-46.

[238] *Id.*

[239] 659 N.E.2d 1096, (Ind.App. 1996).

[240] *Id.*, at 1101.

[241] *Id.*

[242] *Id.*

[243] 981 F.2d 850 (5th Cir. 1993).

[244] *Id.*, at 851.

association regulator. The court consulted *Black's Law Dictionary*[245] and determined that there was nothing in the ordinary interpretation of takeover to limit the word to only hostile or involuntary changes in control.[246] Similarly, in *FSLIC v. TransAmerica Insurance Co.*[247] the FSLIC urged that a "physical possession of the institution" requirement was implied in the automatic takeover provision. The FSLIC sent a notice of loss under the bond on the date it was appointed receiver, and thus coverage terminated.[248] As a result, the agency sought an expedient argument to advance the discovery and notice provision a single day forward before the date of termination. Looking to the law of receivership, the court found that legal right to possession and control was effective immediately at the time of appointment.[249] Physically entering the premises of the institution was not necessary to effectuate a takeover.[250]

The court in *TransAmerica Insurance* also rejected a public policy argument that was first discussed in the 1987 case of *FSLIC v. Oldenburg*.[251] *Oldenburg* held that the automatic termination provision was void as against public policy because it interfered with the FSLIC's normal rights and powers of successor to enforce the contracts of the institution.[252] This rationale was later adopted by other district courts[253] until a series of federal appellate decisions uniformly held that these decisions had improperly applied public policy criteria and ignored a

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[245] 1454 (6th ed. 1990).

[246] 981 F.2d at 851.

[247] 705 F.Supp. 1328 (N.D. Ill. 1989).

[248] *Id.*, at 1337.

[249] *Id.*

[250] *Id.*

[251] 671 F.Supp. 720 (D. Utah 1987).

[252] *Id.*, at 671 F.Supp. 722-24.

[253] *E.g., FSLIC v. Aetna Casualty & Surety Co.*, 701 F.Supp.1357, 1363 (E.D. Tenn. 1988); *Branning v. CNA Insurance Companies*, 721 F.Supp. 1180, 1183-84 (W.D. Wa. 1989).

provision in FIRREA that qualified successor rights.[254] In the first such case, *FDIC v. Aetna Casualty & Surety*, [255] the Sixth Circuit Court of Appeals emphasized that rights governed by contract should not be lightly modified by the courts to conform with "general considerations" of public policy.[256] Rather, under United States Supreme Court standards, the terms of a contract may not be disturbed unless the offending provision conflicts with a well defined and dominant policy that can be ascertained from existing law and legal precedent.[257]

Not only were the general powers of the regulator as receiver not held sufficient to abrogate the termination provision under this analysis, but the court found statutory support for the opposite conclusion under FIRREA. Thus, under Section 1828(e) of the statute, contractual acceleration and forfeiture on insolvency clauses are invalidated.[258] However, both directors and officers liability policies and financial institution bonds were expressly exempted from this general prohibition on impairing the receiver's rights as a contractual successor.[259] Based on this provision, the requirement of an explicit law or precedent could not be satisfied. Rather, the statute was explicit that bonds were exempted from the anti-forfeiture law.[260] Thus, the automatic termination provision was held fully enforceable against a receiver.[261]

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[254] *E.g., California Union Insurance Co. v. American Diversified Savings Bank*, 948 F.2d 556, 562 (9th Cir. 1991); *St. Paul Fire & Marine Insurance Co. v. FDIC*, 968 F.2d 695, 702 (8th Cir. 1992); *Fidelity and Deposit Company of Maryland v. Connor*, 973 F.2d 1236, 1241-43 (5th Cir. 1992).

[255] 903 F.2d 1073 (6th Cir. 1990).

[256] 903 F.2d at 1077-78.

[257] *Id.*, at 1077.

[258] *Id.*, at 1078.

[259] *Id.*

[260] *Id.*

[261] *Id.*

B. Automatic Cessation of Directors and Officers Liability Coverage

In the case of directors and officers liability policies, there has been one challenge to an automatic termination provision, but not on public policy grounds.[262] In *American Casualty Co. v. FDIC*,[263] the court was called on to determine whether an automatic termination provision terminated coverage after the institution had purchased so-called "discovery period" coverage after the policy had been non-renewed.[264] The FDIC argued that the provision "coverage shall cease" only served to terminate the policy during the original policy period.[265] The agency argued that the discovery period was an independent right and agreement under the policy allowing reporting of claims notwithstanding that coverage had ceased on the actual expiration of the policy.[266] The agency urged that, at best, there was an ambiguity as to whether the termination clause terminated rights under the original policy to purchase such additional coverage.[267]

The district court rejected this argument on the grounds that the interpretation could not be reconciled with other provisions of the cessation of business clause. In particular, the provision stated that, after cessation of business, "the bank shall not be entitled to obtain the extended coverage provided for in Clause 2(b)" (which referred back to the discovery clause).[268] The court noted that the discovery period coverage was a form of insurance coverage and thus had to

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[262] *American Casualty Co. of Reading, PA v. FDIC*, 821 F.Supp.655 (W.D. Okla. 1993), *aff'd*, 33 F.3d 62 (10th Cir. 1994).

[263] 821 F.Supp. 655 (W.D. Okla. 1993).

[264] *Id.*, at 659-60. This coverage is also sometimes referred to as "extended tail" or "extended reporting" coverage.

[265] *Id.*, at 661.

[266] *Id.* at 661-62.

[267] *Id.*

[268] *Id.*, at 659.

terminate once all coverage ceased.[269] Since the very right to purchase discovery period coverage terminated at closure, it was illogical to conclude that the identical coverage would continue if purchased prior to closure.[270]

The Tenth Circuit Court of Appeals affirmed the decision in an unpublished case.[271] The Court of Appeals entertained additional legal arguments regarding the termination provision. This included an argument that the institution did not receive sufficient advance notice of the import of the clause at the time the policy was purchased.[272] As to this argument, the court noted that the reorganization clause had been added by endorsement.[273] The endorsement was separately scheduled at the time of renewal. Since there had never been a misrepresentation that the prior policy was being renewed without material modification, the court found the provision was conspicuous enough to satisfy Oklahoma law in the case of insureds who were "sophisticated bankers."[274]

Second, the Court of Appeals considered the argument that the right to terminate had been waived because American Casualty had never returned pro rata premium for the time after which coverage had ceased.[275] The court rejected this argument on the grounds that there is no obligation to return premium in the case of a policy which automatically lapses in the event of

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[269] *Id.*, at 661.

[270] *Id.*

[271] *American Casualty Co., supra,* 33 F.3d 62 (10th Cir. 1994).

[272] *Id.*, at 2.

[273] *Id.*

[274] *Id.,* at 2-3.

[275] *Id.* at 4.

specified events.[276] An insured who purchases such coverage assumes the risk that the policy may lapse and its premium might cover a shorter period due to the cessation of business.[277]

VI. DISCOVERY PROVISIONS

A. General Considerations

As a general matter, rights under the discovery and reporting provisions of bonds and liability policies are neither enhanced nor impaired up to the time of the appointment of a receiver. However, the automatic termination provisions of both forms of insurance create practical difficulties for the agency in its efforts to preserve and maximize the institution's rights under the policies as they may exist on the eve of closure.

In neither case are the time constraints so severe as to completely undermine the agency's ability to preserve the status quo. The 2004 Bond requires reporting "at the earliest practicable moment, not to exceed 30 days."[278] The better practice in the case of any financial institution bond is for the agency and the institution to both develop the necessary factual record to report a bond claim and to report the loss before or close to the time of closure.[279] In the states that may still apply a "notice/prejudice" approach to the period of reporting after closure, the notice of loss will still be

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[276] *Id.*, at 4.

[277] *Id.*, at 4.

[278] 2004 Bond, Conditions and Limitations, § 5(a).

[279] *E.g., California Union Insurance Co. v. American Diversified Savings Bank*, 948 F.2d 556, 564-65 (9th Cir. 1990) (Court faulted FSLIC for not bringing evidence of dishonesty to attention of non-wrongdoing employees before termination of bond); *FSLIC v. Aetna Casualty & Surety Co.*, 785 F.Supp. 867 (D. Mont. 1990) (Reporting found untimely where Federal Home Loan Bank Board waited a year from discovery to direct management to file bond claim).

deemed timely as long as the FDIC can establish that non-involved employees discovered facts supporting a reasonable belief that there might be a covered claim before termination.[280]

However, a decision to wait any longer than the normal thirty-day maximum period from discovery specified in the 2004 Bond has substantial risks. First, many jurisdictions have declined to superimpose a notice/prejudice standard on the thirty-day period within which to report.[281] Moreover, many of the notice/prejudice cases were decided under financial institution bonds issued before 1986 and 2004 respectively. The 2004 Bond and its predecessor 1986 Bond added the "not to exceed 30 days" provision.[282] In *FDIC v. Oldenburg*,[283] the Tenth Circuit Court of Appeals, applying Utah law, determined that even the "not to exceed" language was subject to a notice/prejudice standard. However, later cases have declined to follow *Oldenburg*.[284] Thus, once the facts appear to objectively support the tender of a claim, it is dangerous to wait more than thirty days in any state.

As to directors and officers liability policies, the potential claims notice provisions of contemporary policies generally provide a grace period of thirty days or more after expiration to

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[280] *FDIC v. Oldenburg*, 34 F.3d 1529, 1546 (10th Cir. 1994) (Collecting cases allowing for reporting under notice/prejudice standards).

[281] *FSLIC v. Aetna Casualty & Surety Co.*, *supra*, 785 F.Supp. at 871 (Montana law); *FDIC v. St. Paul Companies*, 634 F. Supp. 2d 1213, 1224 (D. Colo. 2008) (Montana law).

[282] FINANCIAL INSTITUTION BOND, STANDARD FORM NO. 24, General Agreements, F., (revised January 1986), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA) (hereafter the 1986 Bond).

[283] 34 F.3d 1529, *supra*, at 1546.

[284] *See, e.g., FDIC v. Insurance Co. of North America*, 105 F.3d 778, 783-87 (1st Cir. 1997); *FDIC v. St. Paul Companies*, *supra*, 634 F. Supp. 2d at 1223-25.

report a potential claim.[285] However, as in the case of bonds, these deadlines are normally strictly enforced.[286]

These time constraints create difficulties for the regulators that lead to disputes as to the timing of discovery, the timeliness of reporting, and the methods the FDIC often uses to attempt to preserve coverage near the time of closure. If the institution itself is not diligent in preserving its rights before a closure, there may be little the regulators can do prior to that time to preserve coverage.

Thus, in the period before closure, the regulators' attention and resources are divided among many competing priorities. The FDIC's evaluation of what it characterizes as "professional liability claims" is a post-closure aspect of the overall resolution process.[287] In the period before closure, resources are devoted to forward looking issues with respect to institutions on the Problem Bank watch list.[288] With over 800 banks now in that category, the resources of the regulatory agencies are spread thin. The focus before closure is generally not to look back for scapegoats, but to determine whether the institution has sufficient capital and performing assets to survive as a going concern.[289] Even when closure is imminent, there are a host of complex resolution tasks that may take precedence over investigating insured losses and liability

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[285] *BancInsure, Inc. v. The Park Bank*, 318 F. Supp. 2d 746, 748 (W.D. Wis. 2004).

[286] *E.g., California Union Ins. Co. v. American Diversified Savings Bank*, 914 F.2d 1271, 1278 (9th Cir. 1990) (Notice of regulatory activity by regulators did not suffice to satisfy potential claim reporting provisions); *FDIC v. Barham*, 995 F.2d 600, 605 (5th Cir. 1993) (Awareness of regulatory compliance directive by insurer's agent did not satisfy potential claim reporting provisions of policy).

[287] *Managing the Crisis, the FDIC and RTC Experience*, Chap. 11 (1998), Professional Liability Claims, pp. 265-67.

[288] FDIC Quarterly Banking Profile, March 31, 2011 (Reporting 888 institutions identified as problem banks).

[289] *See, FDIC Resolutions Handbook*, Ch. 5, Open Bank Assistance Transactions, p. 47 *et seq.*, Ch. 6, Other Resolution Alternatives, p. 57 *et seq.*

claims.[290] Given these exigencies, efforts to preserve insured claims are often hastily developed on the eve of closure. The FDIC in many instances attempts to accomplish that which only the insured institution is in a position to undertake. Thus, the agency itself has conceded:

> … Professional liability claims are complex and contentious and often require many years and substantial investments in investigation and litigation before any actual recovery is realized.[291]

Moreover, in the case of bond claims, investigating dishonesty claims, not previously uncovered in regular examinations, can be a doubtful investment of resources. This is not surprising, given the high levels of proof needed to establish a covered bond claim. In the prior bank failure crisis, of the $2.5 billion in recoveries indemnified by all insurance, the bank regulatory agencies only succeeded in recovering $300 million in financial institution bond recoveries.[292]

B. Perfecting a Bond Claim on the Eve of Closure

Where management and the regulators develop a detailed and well-documented record to support a notice of a loss by or near the time of closure, the opportunity to perfect collectible bond claims are best. The case of *RTC as Receiver for City Savings, F.S.B. v. Fidelity and Deposit of*

[290] *Managing the Crisis, supra*, Ch. 2, Overview of the Resolution Process, pp. 55-61.

[291] *Managing the Crisis, supra*, Ch. 11, Professional Liability Claims, p. 266.

[292] *Id.*, at 285.

Maryland[293] provides an example. The claim was made just before the failure of City Federal, a savings institution eventually taken over by the Resolution Trust Corporation ("RTC").[294] There dishonest insiders arranged for the cover up of losses associated with the extension of a $30 million warehouse line of credit to Northwest Mortgage Company ("Northwest").[295] Northwest was a mortgage broker that originated and resold mortgages to investors or investment pools.[296] This concealment went on for a period of years until Northwest's owner, Movroydis, confessed that Northwest was substantially in default and that he had misappropriated loan proceeds over which the institution believed it had perfected a security interest.[297] The fraud began in early 1988 and was not discovered until February of 1989.[298]

Based on this confession and employee interviews, bank officers and the institution's in-house attorney suspected but could not fully confirm that these losses were the product of insider collusion with Movroydis.[299] The bond in the *City Savings F.S.B.* contained language somewhat similar to that found in Section 3 of the current 2004 Bond.

> Section 4. This bond applies to loss discovered by the Insured during the bond period. Discovery occurs when the Insured becomes aware of facts which would cause a reasonable person to assume that a loss

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[293] 205 F.3d 615 (3d Cir. 2000)

[294] *Id.*, at 625.

[295] *Id.*, at 620-21.

[296] *Id.*

[297] *Id.*, at 624-25.

[298] *Id.*

[299] *Id.*

> covered by the bond has been or will be incurred, even though the exact amount or details of loss may not then be known.[300]

As the court recognized, the provision contains both an objective standard, that is, the requirement that specific facts be discovered, and a hypothetical subjective standard, that is, that the facts would lead a reasonable person to conclude a covered loss might be experienced.[301] Under this standard, the trier of fact must first evaluate the facts known respecting the underlying wrongful conduct and then determine whether a reasonable person would assume that a loss potentially covered by the bond may have resulted.[302]

The insurer moved for summary judgment on the grounds that the information available to the employees that discovered and reported the claim was insufficient to meet the first prong of the test.[303] The carrier urged that the employees had no hard and fast information that insiders had facilitated the loss in the period before the bond expired in March of 1989.[304] The district court agreed and granted summary judgment.[305]

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[300] 205 F.3d 615; See, 2004 Bond, § 3. The 2004 Bond substituted the phrase "loss of the *type* covered by the bond" (emphasis added) to underscore that the discovery provision does not require the insured to recognize the loss is actually covered. *See*, Keeley, *Annotated Financial Institution Bond* (2d Ed.) p. 423.

[301] *Id.*, at 630, *citing, United States Fidelity and Guaranty Co. v. Empire State Bank*, 448 F.2d 360, 365 (8th Cir. 1971).

[302] *Id.*

[303] *Id.*, at 625-26.

[304] *Id.*

[305] *Id.*

In reversing, the Third Circuit Court of Appeals first noted that the RTC stood in the shoes of the institution.[306] If the discovery clause had been satisfied before closure, the RTC could seek indemnification for the loss.[307] After surveying existing precedent on the discovery standard, the Court of Appeals emphasized that the discovery standard under contemporary financial institution bonds was expressly formulated to establish a low and early standard of discovery and reporting.[308] This objective of requiring reporting sooner rather than later is designed to avoid prejudice to the insurer that results from delay and the incident staleness and unreliability of the record needed to investigate the claim.[309]

The facts learned must lead to a reasonable suspicion, rather than an actual belief that a loss covered by the bond may have occurred.[310] There was no claim that the district court had applied the wrong standard.[311] However, the Court of Appeals faulted the trial court for misapplying that standard.[312] The lower court evaluated the separate reasons the institution determined to file the notice of loss on a fact-by-fact basis, rather than considering the "totality of the information the management of the institution had before it."[313]

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[306] *Id.*, at 627.

[307] *Id.*

[308] *Id.*, at 630-31.

[309] *Utica Mutual Ins. Co. v. Fireman's Fund Ins. Companies*, 748 F.2d 118, 121 (2d Cir. 1984).

[310] *Id.*, at 632-33.

[311] *Id.*

[312] *Id.*

[313] *Id.*

Thus, a last minute change in the terms of a major acquisition just before the fraud was discovered was a major factor considered by the general counsel of the association in reporting the claim.[314] HonFed Bank had purchased a subsidiary of the institution.[315] On the eve of closing, HonFed insisted that the Northwest loan be eliminated from the subsidiary's portfolio and remain with the parent company, City Federal. Coincidentally, former insiders of City Federal, who had been involved in the cover up of the Northwest problems, secured positions with HonFed in connection with the sale of the subsidiary.[316]

Similarly, the general counsel found it suspicious that a remaining loan officer, DeVany, admitted knowledge of Northwest's substantial default by December 1988 and halted further funding of the credit line at that time.[317] However, DeVany had no explanation as to why, contrary to bank policy, he had never reported his findings to the legal department before Movroydis made his own confession several months later.[318]

Factors as subtle as DeVany's demeanor during interviews by the legal department were considered by the Court of Appeals in combination with other information.[319] Also critical was the general counsel's incredulity that an outside institution, HonFed, had singled out the disastrous line of credit for elimination from the acquisition, but City Federal insiders somehow

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[314] *Id.*

[315] *Id.*

[316] *Id.*

[317] *Id.*

[318] *Id.*, at 622-28.

[319] *Id.*

were unaware of the identical problems.[320] Based on all the foregoing factors, the Court of Appeals found there was a reasonable question of fact as to whether the facts known met the discovery clause standards.[321]

The Court of Appeals emphasized that the discovery clause criteria is highly factual.[322] This fact intensive test naturally opens the door for the FDIC to identify speculative badges of fraud in the limited time that may be available near or after closure to perfect a claim. If more definitive evidence is not available, a common tactic is to construct a "laundry list" of loans that had early default histories, that were substantially under collateralized or that otherwise raise red flags. Evidence that a particular loan officer had a high frequency of defaults, independent relationships with borrowers that may have created conflicts of interest, or poorly documented loan files, may also support claims notices. Further, third party claims by borrowers alleging fraud or other improper conduct may be cited as grounds for reporting.[323]

However, none of these efforts are likely to succeed unless the agency can ultimately confirm that insiders had reasonable familiarity with the relevant facts before the bond terminated.[324] When the best an employee can say is that he or she suspected fraud based on regulatory

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[320] *Id.*, at 627-28.

[321] *Id.*, at 630-31.

[322] *Id.*, at 631 (Inevitably, a court must assess each case on its own facts, keeping in mind the general principle that the "discovery threshold is low").

[323] *See, FDIC v. Insurance Co. of North America*, 105 F.3d 778, 782 (1st Cir. 1997) (Third party borrower claims trigger discovery – FDIC's claim of deferred discovery rejected).

[324] *E.g., FDIC v. New Hampshire Insurance Co.*, 953 F.2d 478, 485 (9th Cir. 1991) (Grand jury indictment corroborated that insider had discovered dishonest employee's conduct before bond expired).

criticisms or the general decline of the bank, courts have held that the discovery standard is not satisfied.[325]

To avoid this problem the agency may undertake to enlist an innocent official and educate that individual to the agency's suspicions and supporting evidence on the eve of closure. One such recent decision dealt with a claim arising out of just such an effort. The decision in *St. Paul Mercury Insurance Co. v. FDIC as Receiver for Hamilton Bank*[326] might aptly be described as the case of *The Wrong Man*.[327] The Hamilton Bank failure occurred in 2002 and was thus unrelated to the mortgage meltdown.[328] The failure was allegedly precipitated by a series of highly questionable loans to foreign borrowers and alleged efforts to cover up loan losses by Hamilton's CEO, Eduardo Masferrer, through loan swaps.[329]

On the eve of closure, the OCC enlisted the bank's CFO, Timothy Harris, to sign a notice of loss.[330] To support the institution's discovery of misconduct by Masferrer in connection with a loan known as the Golden Vision loan, the OCC representatives showed Harris the Golden

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[325] *E.g., California Union Insurance Co. v. American Diversified Savings Bank*, 948 F.2d 556, 564-65 (9th Cir. 1991) (Mere knowledge of extensive regulatory criticism and alleged banking regulation violations not equivalent to facts supporting suspicion of fraud); *FDIC v. Aetna Casualty & Surety Co.*, 953 F.2d 478, 485 (9th Cir. 1991) (Subjective suspicions of fraud not corroborated by specific evidence of fraudulent conduct not sufficient to satisfy discovery clause).

[326] 2011 WL 1195402 (S.D. Fla. 2010).

[327] This was an Alfred Hitchcock film based on a case of mistaken identity taken from Maxwell Anderson's *The True Story of Christopher Emmanuel Balestero*.

[328] 2011 WL 1195402, at 1.

[329] *United States v. Masferrer*, 514 F.3d 1158 (11th Cir. 2008).

[330] 2011 WL 1195402, at 2.

Vision loan file.[331] The agency representatives showed Harris that the loan file had virtually no documentation.[332] They further provided evidence that the loan had been funded through a suspiciously circuitous series of wire transfers for an acquisition of distressed assets from a bank in El Salvador, Unibanco.[333] Masferrer was known to own shares in Unibanco.[334] The OCC showed Harris that its investigation established that no security interest in the loan had been perfected.[335] The OCC also pointed out that Golden Vision was a newly formed British Virgin Island company with no track record from which the bank could readily confirm an independent financial ability to repay the loan.[336]

In the ultimate notice of loss Harris asserted that this factual evidence had led him to reasonably assume Masferrer had masterminded and benefitted from the alleged sham loan transactions.[337] In its ensuing investigation, the FDIC learned that the dishonest party who had concocted and stood to benefit from the scheme was in fact Ronald Lacayo, a Hamilton director.

St. Paul moved for summary judgment based on the disconnect between the belief formed by Harris at the time he reviewed the evidence provided by the OCC and the actual claim of dishonesty based on the dishonesty of a completely different employee, Lacayo.[338] St. Paul

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[331] *Id.*

[332] *Id.,* at 2-4.

[333] *Id.*

[334] *Id.*

[335] *Id.*

[336] *Id.*

[337] *Id.*, at 4.

[338] *Id.*, at 4.

reasoned that, if the facts led Harris to suspect dishonesty other than that actually committed, there could be no coverage.[339]

The court rejected St. Paul's argument on several grounds. First, the court dealt with St. Paul's assertion that it was necessary that Harris assume that the right man, Lacayo, was engaged in dishonesty of a type covered by the bond. The court noted that Harris was confronted with nine separate facts that would have led him to believe that there was employee dishonesty on the part of some insider.[340] The court rejected the argument that Harris had to correctly identify the dishonest employee to reach the discovery threshold provided under the bond.[341] It held that to do so would be equivalent to imposing a non-existent requirement that the innocent employee correctly interpret all the facts presented to him when in fact the test is whether a reasonable person could make the assumptions Harris made based on the facts before him.[342]

Second, St. Paul argued that the "covered by the bond" test had not been satisfied, because the facts known to Harris could only support an awareness or suspicion of poor or irregular business activities.[343] The court acknowledged that unsafe and unsound lending practices in and of themselves would not objectively support such suspicions.[344] The court first noted that the cases relied upon by St. Paul in support of its arguments were not authoritative in light of the bond

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[339] *Id.*, at 4-5.

[340] *Id.*, at 4.

[341] *Id.*

[342] *Id.*

[343] *Id.*, at 5.

[344] *Id.*, at 5, *citing RTC v. Fidelity and Deposit of Maryland*, 205 F.3d 615, 630 (3d Cir. 2000).

language before it.[345] As the court correctly observed, many of these cases, dating from the late nineteenth century Supreme Court case of *American Surety Co. v. Pauly,*[346] contained provisions that required a showing that the insured was actually satisfied and/or reasonably believed covered dishonesty had transpired.[347]

Under the provision before the court, it was not necessary that the insured pass the threshold of suspicion to a point where the employee reasonably believed the employee could be charged with fraud or dishonesty.[348] Rather, relying on a prior Eleventh Circuit decision in *Royal Trust Bank N.A. v. National Union & Fire Insurance Co*.,[349] the Court held that the suspicion standard applied in the Eleventh Circuit required no element of satisfaction, belief or confirmation.[350] The Court ruled that, unless no reasonable juror could conclude Harris' suspicions were justified, summary judgment could not granted:

> That Harris was mistaken about who actually masterminded the fraud and benefitted therefrom does not diminish the point that a fact-finder could conclude that a reasonable person would have assumed that the losses incurred by reason of the Golden Vision loan were due to an employee's fraudulent or dishonest conduct and that that employee had benefitted therefrom. The Court cannot say that, as a matter of law, this suite of facts would cause a reasonable person to, **at most**, merely suspect that fraudulent or dishonest conduct was afoot.[351]

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[345] *Id.*, at 5.

[346] 170 U.S. 133 (1898).

[347] *Id.*, at 5.

[348] *Id.*, at 6.

[349] 788 F.2d 719 (11th Cir. 1986).

[350] *Id.*, at 6.

[351] *Id.*, at 6.

Hamilton Bank provides a good example of how a successor may potentially perfect (although not necessarily establish) a bond claim. The actual feasibility of developing the quantum of proof put before Harris in *Hamilton Bank* will not be easy to duplicate in many cases. However, the decision shows that evidence supporting a reasonable suspicion of fraud will suffice even if the specific assumptions made at the time notice is provided prove erroneous in the long run.

On the other hand, other decisions establish that a lucky guess that is corroborated over the long run will not save an untimely claim. When the factual record has not been fully developed to satisfy the standards of the clause before the bond terminates there will be no coverage.

C. The Perils and Possibilities of Laundry Listing Under a Liability Policy

Similar issues and disputes arise under the potential claims notice provisions of directors and officers liability policies. However, the FDIC has some advantages in preserving potential coverage under this type of policy. First, the level of misconduct to support liability is lower under FIRREA at a standard potentially no lower than that of a gross negligence standard.[352] Moreover, as to breach of fiduciary duty claims, the FDIC receives the benefit of any lower standard of care that applies under state corporate law.[353] Second, as the likely adverse claimant,

[352] *Atherton v. FDIC*, 519 U.S. 213 (1997).

[353] *FDIC v. Castetter*, 184 F.3d 1040, 1043-44 (9th Cir. 1999) (Simple negligence standard under California law).

the FDIC is in a position to control its own destiny by placing the directors and officers on notice of potential claims at or near the time of closure.

This still leaves the question of whether a potential claim notice letter from the agency to directors and officers satisfies the operative reporting provisions of the policy.

Although the law is highly conflicting on the subject of the adequacy of the notice, there are some points on which most courts agree. First, the reporting requirements are not subject to notice/prejudice limitations. Most courts agree that the potential claim notice must be timely submitted by the insured to the carrier before the time to report potential claims expires.[354] Similarly, the courts have generally rejected claims that the insurer was on "constructive notice" based on information it receives through avenues other than a formal written notice specifying the reasons a claim is anticipated.[355] A common unsuccessful argument is that information provided to the carrier in the course of underwriting the policy suffices to provide notice. One such case was *American Casualty Co. of Reading v. Continisio.*[356] In rejecting the argument that information in a renewal application satisfied the potential claim notice reporting requirements, the court stated:

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[354] *E.g., KPFF, Inc. v. California Union Insurance Co.*, 56 Cal.App.4th 963, 966 (1997); *FDIC v. Continental Casualty Co.*, 796 F.Supp.1344, 1352 (D. Or. 1991) (Applying Wisconsin law); *Campbell & Co. v. Utica Mutual Insurance Co.*, 820 S.W.2d 284, 286-87 (Ark. App. 1991).

355 *RTC v. Artley*, 24 F.3d 1363, 1367 (11th Cir. 1994); *American Casualty Co. of Reading, PA v. FDIC*, 944 F.2d 455, 460 (8th Cir. 1991); *California Union Insurance Co. v. Harbor Insurance Co.*, 914 F.2d 1271, 1278 (9th Cir. 1990).

[356] 17 F.3d. 62 (3d Cir. 1994).

> Because the notice of claim provision defines coverage under this policy, the only reasonable interpretation of the policy provision is that the insureds must regard the information they possess as a potential claim and formally notify their insurer through its claims liability department that a claim may be asserted.[357]

The court noted that it was joining "a growing line of cases prohibiting an insured from insisting that its insurer's underwriting department sift through a renewal application and decide what should be forwarded to the claims department on the insured's behalf."[358]

Continisio also illustrates another reason claim notices covering possible regulatory claims may not trigger coverage. There are often material inconsistencies between policy application answers and assertions in potential claim notices tendered near the time of closure. In that case, the signer of the renewal application denied knowledge of circumstances that might lead to the filing of a claim as of the time the application was submitted. Yet the insureds later attempted to rely on documents submitted concurrently therewith in support of their claim that the insurer had notice of circumstances satisfying the reporting provision.[359] The inconsistency did not escape the court's attention as a "yes" answer would have been required to the application question

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[357] *Id.,* at 69, *citing, FDIC v. Barham*, 995 F.2d 600, 604 n. 9 (5th Cir. 1993) (OCC settlement agreement in which bank promised to stop violating federal law was inadequate notice of a claim).

[358] *Id.*

[359] *Id.*

regarding potential claims.[360] The court cited a series of decisions that held that such contradictions create an estoppel supporting a declination of coverage.[361]

A subject on which there has been much less agreement is that of the sufficiency of the potential claims notice itself. A significant problem lies in the fact that, unlike fidelity bond underwriters, directors and officers liability insurers have not been consistent in drafting their potential claim notice provisions. The problem was examined in *FSLIC v. Heidrick.*[362] In that case, the provision stated that a potential claim notice could be submitted if the insureds became aware of "any occurrence which may subsequently give rise to a claim" without any further clarification.[363] Although the information submitted by the directors and officers was very vague in referring to "various loans and projects of the association," the court held that the reporting provision was equally vague and ambiguous and had thus been satisfied.[364]

On the other hand, when the insurer conditions the right to report on providing specific details regarding the grounds for reporting, an overbroad or speculative laundry list generally will not suffice.[365] In *RTC v. Artley*,[366] the insured provided a detailed description of the institution's

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[360] *Id.*

[361] *Id.*, *citing, inter alia, FDIC v. St. Paul Marine Insurance Co.*, 993 F.2d 155, 159-60 (8th Cir. 1993); *American Casualty Co. of Reading v. FDIC*, 944 F.2d 455, 460 (8th Cir. 1991); *FDIC v. Continental Casualty Co.*, 796 F.Supp. 1344, 1352-53 (D. Or. 1991).

[362] 774 F.Supp. 352 (D. Md. 1991).

[363] *Id.*, at 357.

[364] *Id.*, at 358-59; *see also*, *RTC Corp. v. American Casualty of Reading, PA*, 874 F.Supp. 961, 965 (E.D. Mo. 1995) (Similar reporting provision found ambiguous under Missouri law).

[365] *RTC v. Artley*, 24 F.3d 1363 (11th Cir. 1994); *FDIC v. Barham*, 995 F.2d 600, 605 (5th Cir. 1993); *McCullough v. Fidelity and Deposit Co.*, 2 F.3d 110, 113 (5th Cir. 1993).

[366] 24 F.3d 1363 (11th Cir. 1994) (Applying Georgia law).

financial and regulatory woes up to the time of closure but made no effort to identify specific errors or wrongdoing that would potentially support liability claims.[367] The Eleventh Circuit Court of Appeals found this generalized information as to the circumstances leading to the demise of the bank was inadequate to satisfy the potential claims notice provisions of the policy.[368] Finding the reporting provision unambiguous, the Court found no coverage in light of the failure of the directors and officers to describe specific instances of wrongdoing, the individuals involved and to provide supporting documentation.[369]

Similarly, in *FDIC v. Caplan,*[370] the bank's president attempted to incorporate by reference the entire contents of an FDIC examination report criticizing the bank's officers for their "liberal lending philosophy and inadequate supervision of the lending function." The report threatened civil penalties for additional violations and stated the bank was a "problem institution that was likely to face additional regulatory enforcement."[371] The court held that the failure to identify specific wrongful acts and the officers or directors involved did not satisfy the requirement in the that the specific wrongful acts and the actual perpetrators be identified.[372]

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[367] *Id.*, at 1365-66.

[368] *Id.*, at 1367.

[369] *Id.*, at 1367-68.

[370] 838 F.Supp. 1125 (W.D. La. 1993)

[371] 838 F.Supp. at 1128-29.

[372] *Id.*, at 1129-30. *See also, FDIC v. Barham*, 995 F.2d 600, 605 (5th Cir. 1993) (Louisiana law) (Reporting of regulatory criticisms does not equate with reporting of specific wrongful acts).

Other courts have been less rigid construing such provisions. One such case is *Continental Insurance Co. v. Superior Court.*[373] In *Continental Insurance*, the insured entity attempted to trigger coverage as to any and all claims that might arise out of a series of leveraged buyout transactions.[374] Before the policy expired, there was in fact a specific litigation threat made by the unsecured creditors committee of a bankrupt subsidiary previously owned by the parent corporation.[375] Two days before the policy expired, the risk manager of the parent corporation forwarded an extremely broad laundry list which predicted potential claims of creditors and shareholders as to virtually all of the major transactions undertaken by the parent company and its subsidiaries, including the two acquisitions in question.[376] The details of the transactions were identified, but no specific wrongful conduct was identified.[377] The letter stated:

> Claims in the future may be asserted challenging the wisdom of these acquisitions or the management of these businesses after they were acquired, or the distribution of the assets of these companies upon their sale, liquidation, ceasing to do business or other disposition.[378]

A subsequent breach of fiduciary claim against the directors and officers of one of the subsidiaries ultimately was made. Continental argued that the broad letter in question was merely an exercise in speculation, particularly because it did not identify any objectively

[373] 37 Cal.App.4th 69 (1995).

[374] 37 Cal.App.4th at 80.

[375] *Id.*, at 75.

[376] 37 Cal.App.4th at 76.

[377] *Id.*

[378] *Id.*, at 378.

verifiable errors or omissions.[379] The court, however, applied what can be best characterized as a "best efforts" approach to reporting. Since the insureds had "provided all of the information they had," the court found that the laundry list was sufficient.[380]

Such an open-ended best efforts approach creates opportunities for abuse. A common practice is for the FDIC to send its own potential claim notice to the institution around the time of closure stating that claims may be anticipated based on the history of regulatory criticisms. Often a long list of the criticisms is set forth along with a description of the most problematic loans or management practices. This information is in turn forwarded to the carrier, sometimes with embellishment. Thus, the forwarding transmittal letter may also predict that shareholders, creditors and other parties may also be expected to bring claims based on the FDIC notice and a history of criticisms and negative performance.

The routine manner in which such notices are generated casts doubt on their efficacy under objective standards. In 2009, 140 institutions failed, approximately 1.7% of all insured institutions at the time.[381] Virtually no institution has ever undergone an examination without receiving criticisms in an examination report. Failed banks are uniformly subject to criticism prior to closure. Based on the foregoing, reporting potential claims based on criticisms alone is not supportable – otherwise the reporting requirements would be deemed satisfied when the insured can establish the statistical chances of experiencing such a claim are near zero.

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[379] *Id.*, at 80.

[380] *Id.,* at 80.

[381] *Metrix for the Troubled Asset Relief Program*, Congressional Oversight Panel Report (Sept. 16, 2010).

Moreover, the correlation between criticisms prior to closure and the filing of actual claims does not even improve when the statistical data respecting failed banks is examined. Since 1986, the FDIC has brought some form of litigation or enforcement action with respect to 24% of the banks that have failed.[382] In a speech to the House Financial Services Committee of March 2009, FDIC Vice Chairman Gruenberg stated that the FDIC expected to pursue claims in the future according to the same Professional Liability Claim program it had developed in the early 1980s.[383] Since the FDIC sends a letter suggesting claims might be brought based on criticisms in virtually every case, the argument that tendering these letters satisfies the claims reporting provisions is not much better as to failed banks. A court would have to agree that the potential claims reporting provisions are satisfied when the probability of an actual lawsuit is less than one in four. In essence, the phrase "may lead to a claim" would be deemed satisfied in circumstances where history shows the probability is substantially less likely than not.

Moreover, the statistics correlate with the practical reality that the FDIC cannot bring claims in every case mismanagement contributed to a failure. Thus, the agency has to assess that wrongdoing serious enough to support liability under FIRREA exists. As noted above, the agency's resources are tested before closure and it cannot justify investigating FIRREA and bond claims as to institutions that may never fail. Thus, the FDIC concedes it does not even begin to investigate professional liability claims until after closure.

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[382] FDIC Statements of Policy, Statement Concerning the Responsibilities of Bank Directors and Officers (FIL-87-92) (12/3/92). *See generally, Managing the Crisis, supra*, Professional Liability Claims, Ch. 11, pp. 285-87.

[383] *Statement of Martin J. Gruenberg on Federal and State Enforcement of Consumer and Investor Protection Laws* (March 20, 2009), pp. 2-9.

A professional liability investigation is conducted in the case of every failed bank.

> *Immediately following* the closing of *every failed institution* – regardless of size, circumstances or primary federal regulator – our investigations staff and our attorneys who specialize in professional liability issues together begin an investigation. The purpose of the investigation is to determine, among other things, whether the failed institution's directors, officers, and professionals, such as accountants, appraisers and brokers, were responsible for its losses, and, if so, to hold them accountable.
>
> At the closing, our investigators and attorneys will: determine the reason for the bank's failure; look for evidence of potential fraud that may have contributed to the institution's failure; identify any cause of action against directors, officers or other professionals who contributed to the failure; preserve Bankers Bond and Director and Officer insurance coverage for any potential or existing claim; maintain and protect the integrity of the bank's records; and establish the chain of custody for such records.[384]

Thus, by its own admission, at closure the FDIC has not even undertaken to determine whether it either has grounds to pursue a claim, nor whether it will ultimately receive authority to proceed in light of a cost-benefit analysis. The investigation begins at closure and takes time to complete.[385]

As such, FDIC notice letters circulated at closure are a weak indicator of the likelihood of a claim. Moreover, the indiscriminate dissemination of such notice letters serves to undermine their weight and credibility. For that reason, insureds that pass such letters on without a candid

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[384] *Statement on Federal and State Enforcement of Consumer and Investor Protection Laws (*3/20/09) (emphasis added).

[385] *Managing the Crisis, supra,* p. 266.

self-examination and disclosure of whether real versus hypothetical wrongful conduct transpired are likely not in compliance with such provisions.

In any event, given the disparity between how certain jurisdictions interpret and apply claims reporting provisions and the fact intensive nature of the criteria, this is bound to be a fertile area for future controversy and new decisions.

VII. LIMITATIONS PROVISIONS

FIRREA contains a special statute of limitations. It is designed to avoid an inadvertent lapse of the statutes of limitations for contract and tort claims while the FDIC investigates the affairs of the institution.[386] The statute provides for alternative limitation periods of three years for tort claims and six years for contract claims, unless state law provides for a longer limitations period.[387] The statute begins to run from the date of appointment of the FDIC as receiver or the date the causes of action accrues, whichever is earlier.[388]

Normally, the contractual limitations period applicable to bonds and other first party insurance trumps longer periods of time that apply under state law.[389] These abbreviated limitations

[386] 12 U.S.C. § 1821(d)(14).

[387] *Id.*

[388] *Id.*

[389] *Friendly Farms v. Reliance Ins. Co.*, 79 F.3d 541, 545 (6th Cir. 1996) (Strictly enforcing one year limitations period in commercial crime policy).

periods assure that the insurer will have the ability to promptly investigate claims of fraudulent conduct while memories are fresh and pertinent information is available.[390]

Nevertheless, the incredibly long six-year tail applicable to breach of contract claims under FIRREA has been held to trump the standard two-year contract period of a financial institution bond.[391] In *FDIC v. New Hampshire*,[392] the Ninth Circuit Court of Appeals held that the limitations period under FIRREA is preemptive in light of the legislative objectives of the statute.[393] The court found that Congress intended to preempt shorter state law limitations periods to maximize the government's recoveries.[394] The court reasoned that enforcing contractual limitations periods would also interfere with that objective.[395]

The six-year statute does not revive a bond claim that was stale before the receiver was appointed.[396] Thus, in *FDIC v. BancInsure, Inc.*[397] the court held that the six-year statute did not apply when the loss had been discovered more than two years before the appointment of a receiver.[398]

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[390] *St. Paul Fire & Marine Ins. Co. v. Bank of Stockton*, 213 F.Supp. 716, 722 (N.D. Cal. 1962).

[391] *FDIC v. New Hampshire Ins. Co.*, 25 F.3d 478, 486-87 (9th Cir. 1992).

[392] 25 F.3d 478 (9th Cir. 1992).

[393] *Id.*, at 486-87.

[394] *Id.*

[395] *Id.*

[396] *FDIC v. BancInsure, Inc.*, 770 F.Supp. 496, 499 (D. Minn. 1991).

[397] *Id.*

[398] *Id.*

Nevertheless, the FDIC will often request a tolling agreement on claims discovered and subject to notice prior to the appointment of a receiver. Even though it may result in premature litigation, given the extended period to bring suit, it is seldom wise to unconditionally stipulate to such extensions. Once the institution fails, practical difficulties to investigating the claim outside of litigation arise. Employees move on to other jobs, records may be more difficult to obtain and the examination under oath protocol is of no utility. Moreover, if discovery of the loss prior to expiration is challenged, it may be considerably more difficult to determine what was discovered prior to termination if the loss investigation is put off too long.

There may be reasonable grounds to seek such a tolling agreement. Thus, criminal investigations and prosecutions may require deferral of the complete investigation of the loss. However, a better strategy in that situation is to agree to a last date to file litigation to avoid future disputes as to the passage of the limitations period. Another option is to agree to such an extension only if the parties agree on firm deadlines for submitting a sworn proof of loss and otherwise investigating the loss. Thus, it is not unusual for the FDIC to seek and obtain extensions of time to file the proof of loss. An agreement on that point can potentially mitigate the unfavorable consequences of extending the time to file suit. Moreover, in some jurisdictions the suit period is tolled while the carrier investigates the proof and makes its coverage determination.[399]

To avoid the effects of a lapsed claim, the FDIC will often claim that the institution was so impaired by the fraud of prior management that it was incapable of effectively protecting its

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[399] *Compare, FDIC v. Hartford Accident and Indemnity Co.*, 97 F.3d 1148, 1150 (8th Cir. 1996) (No tolling under state law) *with, Prudential-LMI Comm. Insurance v. Superior Court*, 274 Cal.Rptr. 387, 389 (1990) (Applied minority rule of tolling).

rights in perfecting a bond claim before closure.[400] The receiver reasons that the dishonest insiders cannot be expected to blow the whistle on themselves and bring actions, or in the case of bonds, file claims involving their own misconduct.[401] Nevertheless, in practical fact, the instances in which this argument has been successfully raised are limited. As the court recognized in *Karen Kane, Inc. v. Reliance Insurance Co.,*[402] the doctrine does not apply merely because a dishonest employee is capable of covering his tracks and concealing the fraud from management.[403] As occurred in the case of *Admiralty Fund v. Peerless Insurance Co.*,[404] a control group of high ranking corporate officials must have such pervasive control over the insured's operations so as to make the actual discovery and reporting of the wrongdoing impossible.[405]

The pervasive control exception is not easily invoked. In *California Union Insurance Co. v. American Diversified Savings Bank*,[406] the Ninth Circuit Court of Appeals distinguished the *Admiralty Fund* decision on the facts before it. The Court ruled that the adverse domination doctrine did not apply merely because the wrongdoers were key persons within the institution who owned substantial blocks of stock.[407] The key persons had to be so dominant as to render it impossible for uninvolved employees to timely discover the losses supporting the bond claim

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[400] *E.g., FDIC v. Dawson*, 4 F.3d 1303, 1309-10 (5th Cir. 1993); *FDIC v. Cocke*, 7 F.3d 396, 402 (4th Cir. 1993).

[401] *Admiralty Fund v. Peerless insurance Co.*, 191 Cal.Rptr. 753, 759.

[402] 202 F.3d 1180 (9th Cir. 2000).

[403] 202 F.3d at 1189.

[404] 143 Cal.App.3d 379 (1983).

[405] *Id.,* at 389.

[406] 948 F.2d 556 (9th Cir. 1991).

[407] 948 F.2d at 565.

before the takeover.[408] The Court also noted that bank examiners had been investigating the institution for several years and themselves could have brought the information to the attention of employees not involved in the wrongdoing so as to allow for reporting of the loss.[409]

Given the makeup of most contemporary banks, it will be very difficult for the FDIC to successfully raise the adverse domination argument in the future. To comply with corporate governance standards it should be more difficult for a dishonest control group to dominate. Thus, corporate governance audit provisions apply under the Federal Deposit Insurance Act for institutions with assets of $500 million or more.[410] The FDIC and other bank regulatory agencies have historically encouraged voluntary adoption corporate codes of ethics.[411] Internal dishonesty reporting guidelines to detect and prevent bribery and self-dealing have been encouraged by the FDIC since the mid-1980s.[412]

Nevertheless, currently there is limited case law on the application of the adverse domination doctrine in the context of post-receivership insurance disputes. As a general proposition, the law is not well settled in other contexts. For example, under Fifth Circuit precedent, the requirements of the doctrine may be satisfied if the directors involved in the wrongdoing constitute a majority of the board.[413] However, as in the case of *American Diversified Savings*

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[408] *Id.,* at 565-66.

[409] *Id.*

[410] *Joint Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations* (May 6, 2003).

[411] *Id.; FDIC Letter to Chief Executive Officer, Re Corporate Governance, Audits and Reporting Requirements*, FIL-17-2003 (March 5, 2003).

[412] FDIC Statements of Policy (12/31/87) *Guidelines for Compliance with the Federal Bank Bribery Law.*

[413] *FDIC v. Dawson*, 4 F.3d. 1303, 1312 (5th Cir. 1993).

Bank, most courts have required not merely a showing of potential control. Rather, evidence is generally required that such control was exercised to the extent that it was "full, complete and exclusive."[414]

VIII. COOPERATION AND CONFIDENTIALITY AGREEMENTS

Section 7 of Standard Form 24 contains cooperation provisions which are similar to that of most first party insurance policies.[415] In addition to general cooperation and assistance provisions, bonds contain express covenants to provide relevant records and to submit to examinations under oath.[416] When there is an outright refusal to provide records in conformity with such cooperation provisions, a forfeiture of coverage may result.[417] It is generally improper for an insured to condition cooperation on the execution of a blanket confidentiality agreement.[418] There may also be an implied waiver of certain privileges that might otherwise apply as to information that is essential to adjust the claim.[419] Thus, although state privacy laws also now serve to reinforce this requirement, there is an implied obligation between an insurer and insured to share and maintain the mutual confidentiality of information they exchange under the Common Interest Doctrine.[420]

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[414] *Farmers & Merchants Nat. Bank v. Bryan*, 902 F.2d 1520, 1522-23 (10th Cir. 1990); *RTC v. Thomas*, 837 F.Supp.354, 358-59 (D. Kan. 1993) (Noting that in certain circumstances even a minority may effectively control).

[415] 2004 Bond, § 7(d).

[416] *Id.*

[417] *Pilgrim v. State Farm Fire & Casualty Co.*, 950 P.2d 479, 483 (Wash. App. 1997) (Refusal to provide financial records in adjustment of theft claim); *Allstate Insurance Co. v. Hamler*, 545 S.E.2d 12, 14-15 (Ga. App. 2001).

[418] *Pilgrim, supra*, 950 P.2d at 484.

[419] *Waste Management, Inc. v. International Surplus Lines Ins. Co.*, 579 N.E.2d 322, 328 (Ill. 1991); *Allstate Insurance Co. v. Hamler*, 545 S.E.2d 12, 14-15 (Ga. App. 2001).

[420] *Id. See generally,* Windt, 1 Insurance Claims and Disputes 5th, (West 2011) § 3:2.

A significant qualification to this rule is that the interests must be truly common.[421] The doctrine does not interfere with the right of an insurer or an insured to maintain the confidentiality of advice of counsel on matters of dispute between the two parties.[422] Another significant caveat is that the insurer is normally required to prove significant prejudice from the failure to cooperate.[423] Thus, if an insurer has the ability to adjust the claim or make a coverage determination through other sources of information, the breach will usually not support a forfeiture of coverage.[424]

The FDIC is bound as a successor to the provisions of the cooperation clause.[425] However, the leading case on cooperation by the FDIC deals with forfeiture based on an impairment of subrogation rights and not the records and information disclosure requirement.[426] As discussed, an ordinary insured may not condition cooperation on the execution of a broad confidentiality agreement.[427] In addition, insured institutions frequently do not seek such agreements. Both the bank and the insurer are normally constrained by a host of federal and state confidentiality and privacy laws from disseminating information exchanged in the adjustment process.[428]

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[421] *First Pacific Networks, Inc. v. Atlantic Mutual Ins. Co.*, 163 FRD 574, 581 (N.D. Cal. 1995).

[422] *Id.*; *Rockwell International Corp. v. Superior Court*, 26 Cal.App.4th 1255, 1261-64 (1994). S*ee generally*, Donohue, XI Fidelity Law Association Journal (October 2005) *Detective or Advisor – The Attorney-Client Privilege in the Coverage Evaluation*, pp. 75-83.

[423] *Ahmadi v. Allstate Ins. Co.*, 22 P.3d 576, 578 (Colo. App. 2001); *Snyder v. Chester County Mutual Ins. Co.*, 264 F. Supp. 2d 332, 337 (D. Md. 2003).

[424] *Id.*

[425] *FDIC v. Fidelity & Deposit Company of Maryland*, 132 Fed.App'x. 139, 142 (9th Cir. 2005).

[426] *Id.*

[427] *Pilgrim, supra*, 950 P.2d at 483.

[428] *See, e.g.*, Right to Financial Privacy Act of 1978, 12 U.S.C. § 3401 *et seq.*; California Financial Information Privacy Act, Cal. Fin. Code § 4050 *et seq.*; *Russell v. American Real Estate Corp.*, 89 S.W.3d 204, 211-12 (Tex. App. 2002) (Recognizing right of privacy under Texas Constitution).

Nevertheless, the FDIC routinely insists on the execution of a confidentiality agreement in the context of adjusting bond claims after the closure of the bank.[429]

Copies of the specimens the FDIC generally uses as the starting point to negotiate confidentiality agreements are provided in the Appendix.[430] There are three standard forms used in connection with the exchange of information related to the resolution of claims – a bond form, a directors and officers liability form, and a mediation form.[431] As described in the recitals of these documents, the agency bases its right to seek such agreements on regulations promulgated pursuant to its own rulemaking.[432]

In fact, the underlying enabling legislation supporting this rulemaking does not provide a broad grant of authority to maintain secrecy with respect to agency records, nor those of the institution. Rather, such rules are authorized based on *exemptions* found within the Sunshine Act of 1982.[433] The objective of the Sunshine Act is to foster public transparency of federal agency activities.[434] However, there are ten exceptions to this general rule of open access.[435] Exemption 8 of the statute deals most directly with the records of the FDIC itself.[436] Thus, exemption 8 protects "information contained in or related to examination, operating, or condition reports prepared by,

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[429] Keeley, *Superpowers of Federal Regulators, supra*, XVI Fidelity Law Journal at 95-99.

[430] *See* Appendix A.

[431] *Id.*

[432] 12 C.F.R. § 309; 12 C.F.R. § 308.147.

[433] 5 U.S.C. § 552b; *Gregory v. FDIC*, 631 F.2d 896, 897-98 (D.C. Cir. 1980).

[434] 5 U.S.C. § 552b(c); *Common Cause v. Nuclear Regulatory Commission*, 674 F.2d 921, 928, N. 14 (D.C. Cir. 1982) ("It is the purpose of this Act to provide the public with such information while protecting the rights of individuals and the ability of the Government to carry out its responsibilities.").

[435] 5 U.S.C. § 552b(c).

[436] 5 U.S.C. § 552b(c)(8).

on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.[437]

Nevertheless, there are several additional exemptions that may readily apply to records maintained by the agency and the institution both before and after a receivership. In particular, investigatory records compiled for law enforcement purposes are exempt.[438] Commercial and financial information originally provided by a person on a confidential basis is protected as is any information which would be subject to claims of invasion of personal privacy.[439] An exemption which may sometimes apply covers information potentially endangering the stability of a financial institution.[440] Finally, there is an exemption regarding documents generated by the government in the course of participating in civil litigation and administrative proceedings.[441] This exemption is essentially the equivalent the government work product immunity exception.[442]

In light of the open public access policy behind the Sunshine Act, the exemptions in the statute are narrowly construed.[443] No exemption is absolute. A court reviewing a claim of exemption, at a minimum, will consider the following factors:

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[437] *Id.; See, Gregory, supra,* 631 F.2d at 898.

[438] 5 U.S.C. § 552b(c)(7).

[439] 5 U.S.C. § 552b(c)(4), (6).

[440] 5 U.S.C. § 552b(c)(9); *McKinley v. FDIC*, 756 F. Supp. 2d 105, 114-15 (D. D.C. 2010) (Objection to alleged premature disclosure of documents related to government's response to global financial crisis not sustained).

[441] 5 U.S.C. § 552b(c)(10).

[442] *E.g., Clark-Clowitz Joint Operating Agency v. F.E.R.C.*, 789 F.2d 499, 503-04 (D.C. Cir. 1986) (Exemption serves same purpose as attorney-client privilege and work product immunity).

[443] *Common Cause, supra,* 674 F.2d at 932.

1. The relevance of the evidence sought to be protected;
2. The availability of other evidence;
3. The seriousness of the litigation and the issues involved;
4. The role of the government in the litigation; and
5. The possible future timidity by government employees who will be forced to recognize that their secrets are voidable.[444]

Conclusory assertions of an exemption will not be sustained. The agency must provide supporting affidavits establishing both the existence of the exemption and the need to maintain confidentiality in light of the foregoing standards.[445] If necessary, the court may conduct an *in camera* review of the materials.[446] One option available to balance the government's interest with the policy of public disclosure may be to redact portions of the documents.[447] Another option is that of entering into a protective order.[448] Thus, in that respect, the confidentiality agreement accomplishes without judicial intervention the type of relief the court might provide if there were no such stipulation.

One procedural obstacle which may arise in the absence of formal litigation is the need to pursue administrative relief to obtain the documents.[449] Given the blanket request for a confidentiality agreement in post-receivership litigation, one would assume that the FDIC has generally

[444] *First Eastern Corp v. Mainwaring*, 21 F.3d 465, 468 (D.C. Cir. 1994).

[445] *Schreiber v. Society for Savings Bancorp, Inc.*, 11 F.3d 217, 220-21 (D.C. Cir. 1993); *McKinley, supra*, 756 F. Supp. 2d at 113-14 (Agency failed to conduct adequate record search and failed to provide factual support for exemption claims).

[446] *Id.*, at 177.

[447] *Id.*

[448] *Merchants Bank v. Vescio*, 205 BR 37, 40-41 (D. Vt. 1997).

[449] *Denny v. Carey*, 78 FRD 370, 372 (E.D. Pa. 1978).

prevailed in protecting records. That is not the case. For example, in *Merchants Bank v. Vescio,*[450] the FDIC failed to persuade the court that bank records it obtained as successor could be withheld under regulations promulgated by the FDIC and the Federal Reserve Board.[451] The court held that the bank examination privilege embodied an exemption 8 of the Sunshine Act could not be used to shelter the underlying bank records.[452] The court relied upon the Sixth Circuit Court of Appeals decision in *In re Bankers Trust Company*.[453] *Bankers Trust* established the general rule that factual information in bank regulatory records as opposed to commentaries and opinions in examination reports and similar documents were not subject to the exemption.[454] In addition, *Bankers Trust* held that the exemption applicable to deliberative materials was not absolute. In the appropriate case, examination reports could be produced in their entirety.[455]

This principle was applied in *Principe v. Crossland Savings, F.S.B.*,[456] In that case, the court found no useful purpose in protecting examination reports from production in a shareholder class action and derivative case, since the bank had already failed and its assets had been sold to another institution.[457] Given that the agency essentially pursues the same theories of breach of fiduciary duty against directors and officers under FIRREA, it would be hard pressed to distinguish *Principe*.

[450] 205 BR 37 (D. Vt. 1997)

[451] 205 BR at 40-41.

[452] *Id.*

[453] 61 F.3d 465 (6th Cir. 1995).

[454] Thus, the *Vescio* court ruled that the manner in which to balance the competing interests involved was to conduct an *in camera* inspection and/or use the redaction method to protect the portions of examination reports that were truly privileged. *Id.*, at 43.

[455] 61 F.3d at 472.

[456] 149 F.R.D. 444 (E.D. N.Y. 1993).

[457] *Id.*, at 447.

Finally, it is no longer clear that regulatory agencies have a blanket right to object to the production of a Suspicious Activity Report ("SAR"), once believed to be completely immune from discovery once filed with the government. Suspicious Activity Reports were developed based on directives in the Bank Secrecy Act of 1970.[458] The policies behind the legislation are discussed in *California Bankers Association v. Schulz*.[459] The banking industry attempted unsuccessfully to challenge the requirement that banks, in effect, participate in surveillance of customers and other law enforcement activities.[460] The legislative objective at the time was to detect and prevent domestic banks from unwittingly facilitating laundering of funds by organized crime and individuals involved in tax evasion through offshore "secrecy jurisdictions."[461]

There is no requirement within the statute itself that the reporting to the Department of the Treasury by financial institutions be submitted on a confidential basis. Instead, the statute prohibits disclosure of the SAR to the customer or other person whose activities are covered by the report.[462] However, the ultimate reporting rules developed by Department of the Treasury contain extensive disclosure restrictions.[463] The rationale for confidentiality regarding suspicious transactions suggesting a potential violation of law[464] is obvious. The information is

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[458] 31 U.S.C. § 5311, *et seq.*

[459] 416 U.S. 21 (1974).

[460] 416 U.S. 27-29.

[461] *Id.*

[462] 31 U.S.C. 5138(g)(2)(A).

[463] *E.g.,* 12 C.F.R. 21.11(k) (Confidentiality provisions applicable to thrifts); 12 C.F.R. § 563.180(d)(12) (OCC confidentiality rules).

[464] 31 C.F.R. 103.18.

used for law enforcement purposes and any other rule could allow money laundering suspects to learn they are under investigation.

However, given the rigor with which the Financial Crimes Enforcement Network ("FinCEN") of the Department of the Treasury encourages banks to file such reports they have obvious utility when the same investigation that results in the filing of a SAR also results in a financial institution bond claim. Thus, a SAR can often be the best evidence of when and how a financial crime was discovered, who discovered the information, and the key initial documentation that supported the institution's suspicions. The institutions themselves have no right to disclose a SAR.[465] As such, it was previously assumed that the reports were off limits for all purposes. However, in *Bizcapital Business & Industrial Development Corp. v. OCC*,[466] the Fifth Circuit Court of Appeals ruled that there was no absolute prohibition on the disclosure of SAR by an administrative agency.[467] The district court observed that the OCC itself had established a detailed protocol for obtaining production when the exigencies for disclosure were present.[468] Thus, the Court of Appeals agreed that SAR may be disclosed in certain circumstances, not because the OCC's rules improperly banned disclosure in contravention of the Sunshine Act. Rather, the court recognized that the agency itself had authorized a disclosure protocol (in all likelihood, because a blanket prohibition might violate the Sunshine Act).[469]

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[465] *See, Wuliger v. OCC*, 394 F.Supp. 1009, 1014 (N.D. Ohio 2005) (Citing various regulations).

[466] 467 F.3d 871 (5th Cir. 2006).

[467] *Id.*, at 874.

[468] 406 F. Supp. 2d 688, 693.

[469] 467 F.3d at 873-74.

With the bank regulatory agencies so often losing disputes over the withholding of agency and bank records, the question naturally arises as to why any carrier would voluntarily enter into a confidentiality agreement. One obvious rationale is simple expediency. As long as the confidentiality agreement allows for an opt out of its restrictions and independent judicial review of disputed claims of confidentiality, such agreements are more practical than other alternatives. Thus, insurers generally prefer to identify and resolve clear cases of indemnifiable loss as quickly as possible through reliable information.

On the other hand, in closer cases, broad stipulations as to the secrecy of documents can actually interfere with the otherwise smooth investigation and resolution of the claim. The governmental agencies are usually more than willing to disclose information that the institution would ordinarily provide in the ordinary course under the umbrella of a confidentiality agreement. On the other hand, a typical confidentiality agreement does not stipulate that the agencies will automatically provide documents, such as examination reports, that would otherwise be subject to discovery and disclosure in the absence of the exemptions under the Sunshine Act. This may leave the surety with the uneasy feeling that it is stipulating to confidentiality respecting documents that are not confidential at all. A carrier could receive sanitized records based on the ten “cloudy day” exemptions on which regulators may rely in determining which records to produce.

However, there is a second rationale for confidentiality agreements that make them a virtual necessity. Since 1976, the pendulum has swung decidedly in the other direction on the subject of disclosure of bank records of any kind. That holds true for all financial institutions, including

insurance companies. As both a successor and a government agency, the FDIC wears many hats. As receiver, it must abide by laws such as the Right to Financial Privacy Act,[470] as well as rules governing customer privacy under the Fair Credit Reporting Act.[471] The Financial Services Modernization Act of 1999 (also known as the Gramm Leach Bliley Act)[472] added still more restrictions on the disclosure of bank customer information. Moreover, bills enhancing customer privacy still further are under consideration by Congress.[473] These and the many state financial privacy laws that apply to the FDIC, the insurer and also the assuming successor bank that obtains substantially all of the customer records needed to perform the assumption agreement. As a result, there appears to be little choice but to stipulate to confidentiality as to records of the defunct institution. As noted, the Sunshine Act specifically exempts private consumer information.[474]

Because of privacy issues, proceeding without a confidentiality agreement may not be an option in the adjustment of many claims. To the extent they contain mutual provisions to contest confidentiality and the completeness of record productions, the standard forms used by the FDIC appear adequate to protect all interests. As long as the burden is not shifted to the carrier to disprove the application of an exemption, provisions reserving the right to contest confidentiality appear adequate.

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[470] 12 U.S.C. § 3401.

[471] 15 U.S.C. § 1681, *et seq.*

[472] 15 U.S.C. § 6801-6809.

[473] Financial Information Privacy Act of 2011 (HR 653); Do Not Track Me Online Act of 2011 (HR 654).

[474] 5 U.S.C. § 552b(6).

There are, however, certain standard proposed provisions that can be difficult to follow. This includes forms such as the standard "Attachment B," which requires disclaimers to be signed by representatives of the insurance company and the agency. In practical fact, the persons with the most relevant information needed to adjust the bond claim after the institution fails are neither within the control of the insurer nor the receiver. Thus, former bank officials may be unwilling to cooperate in an investigation and abide by a confidentiality agreement, especially if they perceive they are targets of an investigation. In that instance, the parties have little choice but to seek the assistance of a court or administrative law judge in issuing a protective order.

IX. LIABILITY POLICY EXCLUSIONS APPLICABLE TO CLAIMS ARISING OUT OF BANK FAILURES

In the prior bank failure crisis, there were certain policy exclusions that were the subject of substantial litigation. Well before the bank and thrift failure crisis peaked in 1989, certain so-called "financial impairment" exclusions, including regulatory and classified loan exclusions, began appearing in directors and officers and other professional liability policies. Thus, by the time Continental Illinois failed in 1986, some underwriters were already using exclusions designed to limit coverage after a bank failure and takeover.[475] However, such exclusions moved from prevalent to virtually universal over a period of time. In addition, as previously noted, unlike financial institution bonds, policy language varies widely among directors and officers liability underwriters.[476]

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[475] *E.g., FDIC v. Mijalis*, (W.D. La. 1992) (Policy issued effective January 1984 had both regulatory and classified loan exclusions).

[476] *Compare, e.g., St. Paul Fire & Marine Insurance Co. v. FDIC*, 968 F.2d 695, 698 (8th Cir. 1992) (Regulatory exclusion covering claims by regulatory agencies) *with American Casualty Co. of Reading, PA v. Baker*, 758 F.Supp. 1340, 1343 (C.D. Cal. 1991) *aff'd,* 22 F.3d 880 (9th Cir. 1994) (Broader form exclusion covering claims by

Because of differences in language and differences in how such financial impairment exclusions were interpreted as between various jurisdictions, these cases are still important in evaluating current claims. This is so, despite the fact that, by the end of the last financial failure crisis, most were upheld. However, state law controls the interpretation of such provisions. In more cases than not, the highest state court has never had an opportunity to review these provisions nor has any federal court.[477] Moreover, given the extremely low failure rate of institutions between 1997 and 2007, it was not uncommon for underwriters to modify or remove financial impairment exclusions. For that reason as well, disputed claims may be anticipated again.

A. Insured-versus-Insured Exclusions

As noted, even though financial impairment exclusions were introduced in the 1980's, they were far more common by the time the prior bank failure crisis peaked in the late 1980s. Thus, early coverage disputes following a takeover often involved the interpretation of the so-called "Insured-versus-Insured" exclusion.[478] As of the mid-1980's, a typical Insured-versus-Insured exclusion provided:

> 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

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receivers, conservators and liquidators excluded claim by RTC notwithstanding. Reasonable argument that RTC was not a regulatory agency).

[477] *See generally,* Marchitelli, *Validity, construction and effect of "regulatory exclusion" in directors' and officers' liability insurance policy,* 21 A.L.R. 5th 292 (Surveying states that have decided the issue).

[478] *E.g., American Casualty Co. of Reading, PA v. Baker*, 758 F.Supp. 1340, 1343 (C.D. Cal. 1991); *FDIC v. American Casualty Co. of Reading, PA*, 814 F.Supp. 1021, 1025-26 (D. Wyo. 1991); *American Casualty Co. of Reading, PA v. Sentry Federal Savings Bank*, 867 F.Supp. 50, 59 (D. Mass. 1994).

> Officers by any other Director or Officer of the Bank/Association or by the Bank/Association, *except for a shareholders' derivative action* when such action is brought by a shareholder who is neither a Director nor Officer of the Bank/Association nor a beneficial holder of shares for a Director or Officer of the Bank/Association.[479]

The exclusion was originally developed to address "friendly" collusive lawsuits as between insured corporations and their own directors to recoup operational losses through liability insurance.[480] In the context of post-receivership FIRREA claims, the argument was made that the bank regulatory agencies as assignees or successors should be treated no differently than the insured bank or savings institution because the entities "stand in the shoes" of the institution.[481] Some courts accepted this rationale.[482] However, many courts held the typical exclusion did not bar coverage for post-receivership claims by regulators and/or entities established to complete the resolution process, such as the *Resolution Trust Corporation*.[483]

The decisions holding that the exclusion did not bar post-receivership claims by bank regulators relied on a variety of alternative rationales. Some courts held that the exclusion simply did not apply because the successor bank regulatory agency proceeded in one or more capacities other

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479 *Fidelity and Deposit Com. of Maryland v. Conner*, 973 F.2d 1236, 1238 (5th Cir. 1992).

480 *Biltmore Associates LLC v. Twin City Fire Insurance Co.*, 572 F.3d 663, 668 (9th Cir. 2009); *See generally,* Knepper & Bailey, *Liability of Corporate Officers and Directors*, (8th Ed. Matthew Bender 2009) § 25.08, pp. 25-17–29.

481 *See, e.g., Branning v. CNA Insurance Cos.*, 729 F.Supp. 1180, 1184 (W.D. Wa. 1989).

482 *E.g., Fidelity and Deposit Co. of Maryland v. Conner*, 973 F.2d 1236, 1244-45 (5th Cir. 1992) (Case also dealt with enforceability of companion regulatory exclusion); *Powell v. American Casualty Co. of Reading, PA*, 772 F.Supp. 1188, 1191 (W.D. Okla. 1991) (Same); *Hyde v. Fidelity and Deposit Co. of Maryland*, 23 F. Supp. 2d 630, 633-34 (D. Md. 1998) (Same. However, also ruling regulatory investigation did not satisfy claim definition).

483 *E.g., American Casualty Co. of Reading v. Baker*, 758 F.Supp. 1340, 1343 (C.D. Cal. 1991) *aff'd on other grounds*, 22 F.3d 880 (9th Cir. 1994); *Fidelity and Deposit of Maryland v. Zandstra*, 756 F.Supp. 429, 433 (N.D. Cal. 1990) (Summarizing various cases refusing to apply exclusion); *American casualty Co. of Reading, PA v. Sentry Federal Savings Bank*, 867 F.Supp. 50, 59 (D. Mass. 1994).

than strictly as the successor to the institution.[484] Other cases held that the exclusion as it existed at the time was ambiguous as a matter of law.[485] Yet other decisions held that there were factual questions as to the meaning of the exclusion so as to preclude summary judgment as to its application.[486] Still others held that, although the exclusion was potentially ambiguous, the more reasonable reading was that the term "institution" as used in the exclusion referred only to the bank and not regulatory agencies.[487] Some looked at the known underwriting objective of avoiding collusion among insiders and found that, since the government agencies were plainly adverse parties, the exclusion was not intended to cover such claims.[488] In *Fidelity and Deposit of Maryland v. Zandstra*,[489] the district court reviewed the many different and conflicting interpretations of the provisions in earlier cases.[490] In finding the provision before it ambiguous, the court cited the conflicting interpretations of the courts on the subject as evidence that, with so much disagreement, the provision had to be ambiguous as applied to post-receivership claims by regulatory agencies.

Nevertheless, since differences rather than uniformity often distinguishes professional liability underwriting, many of these cases may prove only to have historical value. When the exclusion itself has been shown to cover not merely collusive claims, but claims by successors, that

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[484] *Branning, supra*, 721 F.Supp. 1184-85 (Decision based on fact that FSLIC proceeds in several capacities other than as successor).

[485] *Continental Casualty Co. v. Allen*, 710 F.Supp. 1088, 1098 (N.D. Tex. 1989).

[486] *E.g., American Casualty Co. of Reading, PA v. FDIC*, 713 F.Supp. 311, 316 (N.D. Iowa 1988); *FDIC v. National Union Fire Insurance of Pittsburgh, PA*, 630 F.Supp. 1149, 1157 (W.D. La. 1986).

[487] *American Casualty Co. of Reading, PA v. Sentry, supra*, 867 F.Supp. at 59.

[488] *E.g., FDIC v. National Union Fire Insurance Co. of Pittsburgh, PA, supra*, 630 F.Supp. at 1157.

[489] 756 F.Supp. 429 (N.D. Cal. 1990).

[490] *Id.*, at 434.

language has been upheld. Thus, in *Mt. Hawley Insurance Co. FSLIC*,[491] the exclusion in question covered not only the company and directors and officers, but legal representatives or assigns of either the individual insureds or the company.[492] Because the clause was broader, the provision was found to bar a claim by the FSLIC.[493] Thus, in light of the unfavorable precedent described above, some insurers have expanded their provisions to explicitly exclude claims by successors.[494] The underwriting rationale is self-evident. As the prior bank failure crisis illustrated, post-receivership risks are materially different. The frequency and severity of claims against former insiders is materially greater after an insolvency.

Thus, in *TIG Specialty Ins. Co v. Koken*,[495] the court held that an HMO liquidator was plainly a "successor" within the meaning of a directors' and officers' liability policy. Distinguishing an earlier California case, *Fidelity and Deposit of Maryland v. Zandstra*,[496] the court rejected the notion that, because a statutory successor derives its authority to bring claims from a different source than a voluntary successor, the exclusion did not apply.[497] The court noted the *Zandstra* exclusion did not contain a "successor" provision. In *Zandstra*, the source of the FDIC's powers was germane only to determine whether, in legal effect, the FDIC was the "Association."[498] The

[491] 695 F.Supp. 469 (C.D. Cal. 1987).

[492] *Id.*, at 483.

[493] *Id.*

[494] *TIG Specialty Insurance Co. v. Koken*, 855 A.2d 900, 912-14 (Pa. Commw. Ct. 2004).

[495] 855 A.2d 900, 912-14 (Pa. Commw. Ct. 2004).

[496] 756 F.Supp. 429 (N.D. Cal. 1990).

[497] *Id.,* at 911-12.

[498] *Id.,* at 912.

court noted further that the *Zandstra* court implied it would have reached a different result had the exclusion included successor language.[499]

A similar effort to avoid the effect of a regulatory exclusion which excluded claims by a liquidator was rejected in *Wagner v. United Nat. Ins. Co.*[500] The liquidator argued he was acting in a dual capacity as director and liquidator.[501] However, since the exclusion plainly excluded claims by any liquidator, without limitation, the claim that the suit was brought in an additional capacity was irrelevant.[502]

B. Regulatory Exclusions

The law is now virtually uniform and consistent that a so-called regulatory exclusion is legally valid and unambiguous. These provisions exclude claims by a regulatory agency, receiver or other successor appointed to represent the institution after closure. The FSLIC initially had some success in arguing that a regulatory exclusion violated federal public policy, because it interfered with the statutory powers of the agency to resolve the claims of insured institutions.[503] However, the courts ultimately determined that the enforceability and interpretation of standard provisions such as these are governed by state law.[504] The Courts of Appeals of seven circuits ultimately

[499] *Id., citing*, *Zandstra*, 756 F.Supp. at 433.

[500] 277 Neb. 308, 761 N.W.2d 916 (2009).

[501] 761 N.W.2d at 920.

[502] *Id.*

[503] *Branning v. CNA Insurance Cos.*, 721 F.Supp. 1180, 1183 (W.D. Wash. 1989); *FSLIC v. Oldenburg*, 671 F.Supp. 720, 723 (D. Utah 1987).

[504] *American Casualty Co. of Reading, PA v. FDIC*, 39 F.3d 633, 637-38; *Fidelity and Deposit Co. of Maryland v. Conner*, 973 F.2d 1236, 1243 (5th Cir. 1992).

found such provisions enforceable and unambiguous under state law.[505] The only high court decision that refused to enforce the exclusion on public policy grounds is the Colorado Supreme Court's decision in *FDIC v. American Casualty Co.*[506] The Colorado Supreme Court in that case recognized the provision violated no public policy under federal law.[507] It also found the exclusion in question unambiguous.[508] However, the Court held the exclusion violated the Colorado Public Deposit Protection Act.[509] Other state courts have not followed Colorado's lead.[510]

In rejecting public policy attacks, both state and federal courts have relied upon a rationale first outlined in the Sixth Circuit Court of Appeals decision in *FDIC v. Aetna Casualty & Surety Co.*[511] The case actually dealt with the automatic termination provision of a financial institution bond. The Court held that, under federal law, a public policy violation cannot simply be conjured based on abstract concerns over the overall fairness of a contract provision.[512] Rather, the contract must directly contravene some "explicit public policy," that is, a policy that can be ascertained by reference to specific statutes or legal precedents and not "from general

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[505] *FDIC v. American Casualty Co. of Reading, PA*, 995 F.2d 471, 473-74 (4th Cir. 1993) (Maryland law); *Fidelity and Deposit Co. of Maryland v. Conner*, 973 F.2d 1236, 1242-43 (5th Cir. 1992) (Applying Texas law);*American Casualty Co. v. FDIC*, 39 F.3d 633, 636-639 (6th Cir. 1994) (Applying Michigan law); *American Casualty Co. of Reading, PA v. FDIC*, 16 F.3d 152, 154 (7th Cir. 1994) (Applying Wisconsin law); *St. Paul Fire & Marine Insurance Co. v. FDIC*, 968 F.2d 695, 701-03 (8th Cir. 1992) (Applying Minnesota law); *American Casualty Co. of Reading, PA v. Baker*, 22 F.3d 880, 894-95 (Applying California law); *FDIC v. American Casualty Co. of Reading, PA*, 975 F.2d 677, 680 (10th Cir. 1992) (Applying Oklahoma law).

[506] 843 P.2d 1285, 1290 (Colo. 1992).

[507] *Id.*

[508] *Id.*, at 1290.

[509] *Id.*, at 1294-95.

[510] *E.g., State ex rel. Wagner v. United National Insurance Co.*, 761 N.W.2d 916, 921 (Neb. 2009); *Finci v. American Casualty Co. of Reading, PA*, 593 A.2d 1069, 1075-80 (Md. 1991).

[511] 903 F.2d 1073.

[512] 903 F.2d at 1077-78.

considerations of public interest."[513] The Court reviewed the legislative history of FIRREA and noted that, under the contract enforcement provisions of the statute, Congress had explicitly omitted financial institution bonds and directors and officers liability policies from the provisions of the statute designed to codify the *D'Oench Duhme* doctrine discussed in Section IV., above.[514] The Court noted that, if Congress intended to override the termination provisions of the financial institution bond and require the procurement of post-receivership coverage, it could have explicitly done so.[515]

The rationale of this case was later adopted by decisions that dealt specifically with the regulatory exclusion.[516]

On the subject of ambiguity the regulatory agencies also had initial success in challenging regulatory exclusions only to later suffer a reversal of fortune. For example, in *American Casualty Co. of Reading v. FSLIC*,[517] the court was called on to construe a manuscripted regulatory exclusion.[518] Instead of framing the exclusion with reference to a regulatory agency or successor, the exclusion referred to regulatory claims.[519] Thus, claims for violation of the banking laws were excluded irrespective of the identity of the party bringing the claim. That language was problematic in that successors may also bring breach of fiduciary duty and other

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[513] *Id.*, at 1077-78.

[514] *Id.*, at 1078, *citing,* 12 U.S.C. § 1828(e)(12)(a).

[515] *Id.*

[516] *E.g., St. Paul Fire & Marine Insurance Co. v. FDIC*, 968 F.2d 695 (8th Cir. 1992); *FDIC v. American Casualty Co. of Reading, PA*, 975 F.2d 677, 681-82 (10th Cir. 1992); *Finci, supra*, 593 A.2d at 1076-78.

[517] 704 F.Supp. 898 (E.D. Ark. 1989).

[518] *Id.*, at 902.

[519] *Id.*

common law claims. Thus, the provision was held ambiguous as applied to the facts of that case.[520]

Eventually, the most common provisions both excluded claims by state and federal regulators and also excluded claims by any receiver, trustee, liquidator or other successor.[521] The one trial court that originally construed such broad form language as potentially ambiguous later reversed itself on that position.[522]

Based on the foregoing track record, there is a question as to whether any bank regulatory agency will continue to contest regulatory exclusions in the future. A retrospective report on the poor track record of contesting these provisions suggested that continued efforts to dispute such exclusions were not cost-effective.

> Until 1990, the agencies usually defeated regulatory exclusions by arguing that they were vague, unenforceable, and contrary to public policy. After FIRREA's enactment, however, court decisions have largely upheld regulatory exclusions. In fact, six U.S. Circuit Courts of Appeals cases eventually upheld regulatory exclusions as sufficiently clear clauses negotiated as part of a contract between two parties. In reaching their determinations, the courts relied in part on their finding that Congress had expressed no public policy, in FIRREA or elsewhere, against enforcing regulatory exclusion clauses. …
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> As regulatory exclusions vitiated liability insurance coverage, however, collection efforts shifted to focus more on the particular

[520] *Id.*, at 902-03.

[521] *E.g., American Casualty Co. of Reading, PA, v. Baker*, 758 F.Supp. 1340, 1344 (C.D. Cal. 1991), *aff'd*, 22 F.3d 880 (9th Cir. 1994); *FDIC v. American Casualty Co. of Reading*, 998 F.2d 404, 408 (7th Cir. 1993); *FDIC v. American Casualty Co. of Reading, PA*, 995 F.2d 471, 472-73 (4th Cir. 1993).

[522] *American Casualty Co. of Reading, PA v. FDIC*, 677 F.Supp. 600, 603-04 (N.D. Iowa 1987), *rev'd by, American Casualty of Reading, PA v. FDIC*, 1990 WL 66505 (N.D. Iowa 1990).

> liability of culpable individuals with accessible personal assets. Those persons usually were outside directors, rather than former loan officers.[523]

C. Classified Loan Exclusion

Classified loan exclusions were not developed for the exclusive purpose of excluding claims by regulators or successors of the failed institution. They are typically added at renewal or in quoting a new account when the institution has a sufficient number of classified loans to place it in a higher risk category. Thus, a troubled loan portfolio will not always lead to insolvency, but often leads to a higher experience of lender liability claims. The only published decision to date dealing with classified loans is *FDIC v. Mijalis*.[524] In that case, the classified loan provision stated:

> It is hereby understood and agreed that the Insurer shall not be liable to make any payment for loss in connection with any claim made against the Insured's/Directors or Officers for or arising out of the granting of any loan which shall be deemed classified by any regulatory body or authority.[525]

The decision is of interest in that the court actually found a regulatory exclusion that might have barred coverage for a post-receivership breach of fiduciary duty claim ambiguous and thus unenforceable.[526] Yet, the classified loan exclusion was upheld against assertions that the

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[523] *Managing the Crisis, supra*, pp. 272-73.

[524] 800 F.Supp. 397 (W.D. La. 1992).

[525] 800 F.Supp. at 403.

[526] *Id.*, at 402.

provision violated public policy and was ambiguous.[527] Thus, although the law is limited on this provision, it may also be effective to bar coverage in certain cases.

X. CONCLUSION

By the end of the prior bank failure crisis, insured losses associated with closures began to decrease.[528] As to claims pursued against insurers, there were two basic reasons. First, the industry added financial impairment provisions and also modified existing policy language to further clarify provisions found to be ambiguous. Second, the circuit courts reigned in trial court's that arguably engaged in judicial activism in developing special exceptions for receiver claims that were not supported by law or contract. However, the receiver has preemptive rights in certain areas such as statutory rights negating contractual limitations provisions. Moreover, the discovery provisions of bonds and liability policies allow for coverage of certain post-receivership loss and claims. The increased popularity of bank holding companies has opened the door to new disputes regarding standing. Finally, some coverage issues relating to claims by regulators were never resolved in certain states during the last wave of failures. As such, new coverage disputes and litigation are likely. Hopefully, they will be fewer in number as the health of the economy and the financial services sector improve.

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[527] *Id.*, at 404.

[528] The highest year of all recoveries by far was 1992 when the Drexel Burnham Lambert and Michael Milken settlements were finalized. *Managing the Crisis*, pp. 283-87.