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Client Alert

Insurance Coverage & Recovery Practice Group

August 5, 2014

Avoid the "Insolvency Exclusion" Trap in E&O Policies: Tennessee Federal Court Confirms That Insolvency Exclusion Does Not Apply to E&O Claim Brought By Bankruptcy Trustee Against Financial Institution

As the wave of litigation spawned by the 2008 financial crisis begins to ebb, insurance-coverage litigation arising out of the credit crisis continues unabated. Financial institutions have successfully pursued insurance coverage for many credit-crisis claims under directors and officers (D&O) and errors and omissions (E&O) policies that they purchased to protect themselves against wrongful-act claims brought by their customers, but in response, some insurers continue to raise inapplicable exclusions in an attempt to diminish or limit coverage for their policyholders.

One exclusion found in many E&O policies that some insurers increasingly cite to deny coverage for credit-crisis claims is the so-called "insolvency exclusion." This exclusion, which originally appeared in E&O policies for insurance brokers but later made its way into bankers' professional liability policies, typically bars coverage for a narrow class of claims arising out of the insolvency of certain enumerated third parties. By including this exclusion in their policies, insurers can limit their exposure to certain claims brought against financial institutions, by those financial institutions' own customers, that are completely unrelated to the professional services the insurers agreed to underwrite. The insurers can thereby avoid the risk of becoming a backstop of last resort.

The original idea behind the insolvency exclusion in insurance broker E&O policies was to prevent a broker's E&O insurer from effectively insuring insurance companies that became insolvent—for example, where a broker placed its client's insurance with an insurance company that later went bankrupt. The insolvency exclusion that has become prevalent in bankers' professional liability policies is analogous: it could bar coverage where, for example, a bank acting as a custodian for a customer invests in a fund at the customer's direction that later becomes insolvent. Resulting claims may be excluded if the loss was a result of the bankruptcy of the fund.

An exception found in many insolvency exclusions can be critical: the exception typically carves back coverage if the "insolvency" or "bankruptcy" arises out of the bank's investment advice to the customer. For example, the exception may provide that there is coverage where the customer alleges that it directed the bank to invest the customer's funds in highly liquid and safe securities, yet the bank instead invested those funds in junk bonds that were both illiquid and risky

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investments. In that case, it would be the bank's errors and omissions that caused the customer's losses, and the exclusion would not apply.

Litigation arising out the Madoff Ponzi scheme illustrates how the insolvency exclusion applies. In *Associated Community Bancorp, Inc. v. Travelers Companies, Inc.*, No. 3:09-CV-1357(JCH) (D. Conn.), Associated Community Bancorp was sued by customers seeking to recover losses they incurred after the bank placed their investments in Madoff funds that ultimately collapsed. When the bank tendered the claim to its insurer (Travelers), the insurer denied coverage on the ground that its policy's insolvency exclusion "exclude[d] coverage for losses associated with the insolvency of another firm to which the Bank transferred customer funds for an investment."[1] The district court agreed with Travelers, and the Second Circuit affirmed. This case stands for the principle that where the policyholder bank, as custodian for its customers' money, places that money in a third-party fund that ultimately becomes insolvent, the insolvency exclusion bars coverage—unless the policy contains an exception to the exclusion that otherwise applies.[2]

Another case involving the Madoff scheme—*Aspen Ins. UK, Ltd. v. Fiserv, Inc.*, No. 1:09-cv-02770-CMA-CBS, (D. Colo.)—provides a similar example. In *Fiserv*, a financial institution's customers filed suit against the financial institution after the customers lost their money in connection with the bankruptcy of Madoff funds in which their investments had been placed. The insurers invoked the insolvency exclusion to argue that they "clearly never intended to cover claims or damages arising from the insolvency of a third party broker or dealer."[3] They characterized this conclusion as "self-evident" because "the plain and unambiguous Policy language . . . expressly excludes coverage for claims or damages 'arising out of the bankruptcy of . . . any broker or dealer in securities[.]'"[4]

These cases reflect what was, at least until recently, a general agreement among insurers that the insolvency exclusion's purpose, and its proper interpretation, is to bar coverage for claims where a policyholder's customer sues the policyholder for losses the customer incurred arising from the bankruptcy or insolvency of a *third party* that was not related to errors and omissions by the bank in advising the customer.

As financial institutions continue to seek coverage for credit-crisis claims brought by bankruptcy trustees and receivers of their former customers, some insurers recently have begun arguing that the purpose of the insolvency exclusion is far broader, and that it bars coverage for *all* claims having any nexus with an insolvency or bankruptcy, even the bankruptcy of the financial institution's customer. For example, some insurers now contend that the exclusion would bar coverage if a wrongful-act claim were brought by a financial institution's former customer who happens to be in bankruptcy at the time a lawsuit against the financial institution is actually filed. This expansive reading of the insolvency exclusion transforms otherwise covered wrongful-act claims into excluded claims at the moment in time that a financial institution's customer or client enters bankruptcy. Under this view, there would be coverage the day before the customer files for bankruptcy, but not the day after.

Leaving aside the fact that this reading of the insolvency exclusion defies common sense—coverage should not turn on an arbitrary event such as the date a customer decides to file bankruptcy papers—such a broad reading of the insolvency exclusion is inconsistent with its plain language. A recent decision by a federal district court in Tennessee, *First Horizon National Corporation v. Certain Underwriters at Lloyd's*, No. 2:11-cv-02608, 2014 WL 1331052, at *6 (W.D. Tenn. Mar. 28, 2014) (Mays, J.), illustrates the fundamental problems with an expansive interpretation of the exclusion.

In the underlying lawsuit giving rise to First Horizon's coverage action, First Horizon (the policyholder) had defended and settled claims that it allegedly committed errors and omissions by selling unsuitable securities to one of its former customers. The customer (as opposed to a third party) subsequently filed for bankruptcy, which resulted in the customer's bankruptcy trustee pursuing wrongful-act claims in litigation against First Horizon.

First Horizon's insurers denied coverage, arguing that the insolvency exclusion in First Horizon's bankers' professional liability policy barred coverage. The exclusion provided that an insurer:

> shall not be liable to make any payment for Loss in connection with a Claim made against an Insured . . . alleging, arising out of, based upon or attributable to the bankruptcy, insolvency, conservatorship, receivership or liquidation of, or suspension of payment by, any broker or dealer in securities or commodities, or any bank or banking firm, or any insurance or reinsurance entity, investment company or investment banker or any Insured; provided, however, this exclusion will not apply to Wrongful Acts solely in connection with an Insured's investment on behalf of the claimant in the stock of one of the foregoing entities.

First Horizon filed a motion for judgment on the pleadings asking the Court to rule as a matter of law that the insolvency exclusion was not triggered by the bankruptcy of one of First Horizon's customers. The insurers responded by insisting that the customer's bankruptcy was enough to trigger the insolvency exclusion. In other words, the insurers argued that because the claims were pursued by a bankruptcy trustee, they were necessarily "related to" a bankruptcy, and it did not matter that the bankrupt entity was First Horizon's own customer—and thus the recipient of the very professional services that the insurers agreed to insure.

The Court, in a well-reasoned opinion, disagreed with the insurers' expansive reading of the insolvency exclusion. After first reciting familiar rules of insurance policy construction that exclusions and limitations in insurance policies are to be most strongly construed against the insurer, and that insurers must establish that an exclusion applies in the particular case and that it is subject to no other reasonable interpretation, the Court explained that the insurers' interpretation of the insolvency exclusion was arbitrary and unreasonable. The Court observed that "[a] plain reading of the text of the disputed provision" shows that the exclusion "does not refer to customers of the insured, but only to third-party investment companies in which the insured invests a customer's money."[5] Accordingly, the Court held that "[n]o reasonable interpretation justifies application of the Exclusion when the loss arises from the bankruptcy of a customer of the insured."[6]

To reach this conclusion, the Court conducted a close inspection of the exclusion's language and purpose, and held that the exclusion's text "plainly distinguishes investment companies and customers. Whether the customer allegedly wronged by the insured enters bankruptcy is not material. Instead, the Exclusion excludes coverage when the loss to the customer, and ultimately to the insured, arises from the bankruptcy of a[] [third party] investment company in which an insured places a customer's money."[7]

The Court also considered and rejected the insurers' argument that the purpose of the exclusion was to bar claims brought by customers in bankruptcy, reasoning that this interpretation "is not supported by the text of the Exclusion" and "makes little sense given the purpose of the Policies."[8] This is because "[t]he purpose of an E&O policy is to provide insurance for loss to insureds resulting from claims of wrongdoing made by the insureds' customers."[9] The Court recognized that the Insurers' proposed reading of the Insolvency Exclusion thwarted the purpose of the E&O coverage because it "would arbitrarily limit coverage based on the ability of a customer to absorb the cost of an insured's wrongdoing."[10]

Although insurers such as the defendants in *First Horizon* may be tempted to challenge coverage by advancing overbroad interpretations of insolvency exclusions—as reflected, for example, in ongoing coverage litigation in New York involving another major U.S.-based financial institution where insurers are making similar arguments—such insurers should be chastened by the *First Horizon* Court's flat rejection of this argument. Indeed, in the very same order, the *First Horizon* Court also rejected the insurers' attempt to dismiss First Horizon's statutory bad-faith claim, paving the way for a jury trial on additional penalties based on the insurers' "arbitrary" refusal to pay the claim on the basis of the insolvency exclusion.

We work closely with our clients and their risk managers to ensure that their insurance affords adequate protection in the event of claims, and we have assisted many financial institutions in maximizing coverage for recent unprecedented credit-crisis losses. King & Spalding represented the bank and its affiliates in the First Horizon *suit.*

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[1] Br. of Appellees at 10, *Assoc. Cmty. Bancorp, Inc. v. Travelers Cos., Inc.*, No. 10-2239-cv, 2011 WL 585000 (2d Cir. Feb. 11, 2011).

[2] *Assoc. Comm. Bancorp, Inc. v. Travelers Cos., Inc.*, No. 3:09-CV-1357(JCH), 2010 WL 1416842 (D. Conn. Apr. 8, 2010), aff'd, 421 F. App'x 125 (2d Cir. 2011).

[3] Pls.' Br. in Resp. to Defs.'/Countercls.' Mot. for Partial Summ. J. at 2, *Aspen Ins. UK, Ltd. v. Fiserv, Inc.*, No. 1:09-cv-02770-CMA-CBS, 2010 WL 2314513 (D. Colo. Mar. 9, 2010).

[4] *Id.*

[5] *First Horizon*, 2014 WL 1331052, at *6. The Parties also disputed whether the Insurers could establish that First Horizon's former customer, Sentinel Management Group, was an "investment company" or "broker or dealer in commodities" for purposes of the exclusion. The Court did not reach this issue in its Order.

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.*