ARONBERG GOLDGEHN

Insurance Coverage Update

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Risky Lending Practices Trigger Prior Acts Exclusion

Fraudulent transfers from an insolvent parent to a collapsing bank subsidiary, made after the Prior Acts date, were nevertheless barred from coverage by the Prior Acts exclusion in a D&O policy because they arose from financial missteps that pre-dated the Prior Acts date and caused the insolvency, according to the 11th Circuit in *Zucker v. U.S. Specialty Insurance,* 2017 WL 2115414 (11th Cir., May 16, 2017).

The parent's Chapter 11 plan administrator accused former executives of breaching their fiduciary duties by approving two transfers of tax refunds to the subsidiary bank while the parent was insolvent, a violation of Florida's Uniform Fraudulent Transfer Act. The parent's D&O insurer denied coverage for the executives relying on the Prior Acts exclusion. The D&O insurer argued that, although the fraudulent transfers took place after the November 10, 2008, Prior Acts date, the claim arose out of wrongful acts (risky lending practices that led to the insolvency, an element of the fraudulent transfer claim) committed before the Prior Acts date. The executives settled the claim and assigned their rights under the D&O policy to the administrator.

Before the Prior Acts date, the bank had been under investigation. News articles reported that the bank engaged in risky lending practices. The parent acknowledged in a 2008 regulatory filing that the bank's capitalization rating would be lowered if it did not raise $400 million. Several parent officers were then accused of violating federal securities laws by making false and misleading statements about the bank. The bank acknowledged in agreements with the government it had engaged in unsound lending practices.

In early 2009, after the Prior Acts date of November 10, 2008, the parent transferred $46 million in tax refunds to the bank, leaving the parent with $40 million to service $125 million in debt. Shortly thereafter the bank was closed and the parent filed Chapter 11. The plan administrator pursued the breach of fiduciary duty claims against the executives for the fraudulent transfers, settled, and pursued the D&O insurer for coverage.

The District Court applied the Prior Acts exclusion as the transfers were only fraudulent because the parent was insolvent when they were made and the insolvency resulted from misdeeds that pre-dated the Prior Acts date.

On appeal, the pivotal question was whether the transfers, made after the Prior Acts date, "arose out of" wrongful acts committed before the Prior Acts date. The 11th Circuit noted that Florida courts construe the phrase "arising out of" broadly, even when used in an exclusion. The administrator's own complaint against the executives alleged that they committed wrongful acts before the Prior Acts date that harmed the parent. While insolvency itself is not a wrongful act, an essential element of the fraudulent transfer claim, the parent's insolvency, clearly had a connection to wrongful acts that pre-dated the Prior Acts date. Coverage for the fraudulent

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transfer claims was accordingly barred by the Prior Acts exclusion.

The Court rejected the argument that the Prior Acts exclusion should not apply because the pre-policy misconduct was not incorporated into the fraudulent transfer count and the plaintiff need not establish that the prior misconduct occurred to prevail in the fraudulent transfer claim. The Court noted that coverage and the duty to indemnify is not determined by reference to the complaint but by "reference to the actual facts and circumstances of the injury." The parent's insolvency was a necessary element of the fraudulent transfer claim and the insolvency was admittedly tied to pre-policy misconduct.

Comment:

This appears to be an appropriate application of the Prior Acts exclusion, particularly in light of the "arising out of" language and Florida's broad interpretation of that phrase. The Court also rejected the "illusory coverage" argument of the policyholder noting that the Prior Acts exclusion excludes only a subset of claims that fall within the policy's insuring agreement. Also of note, when the D&O policy was purchased, the insurer presented the option of Prior Acts coverage for more premium but the parent chose instead to purchase higher limits without Prior Acts coverage. This proved to be a costly decision for the parent.

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