ARONBERG GOLDGEHN

Insurance Coverage Update

January 31, 2018

Property Renovation Decisions After Bank Downgrade Not Related to Earlier Risky Lending Practices; Retroactive Exclusion Inapplicable

In the eyes of the Eleventh Circuit, the risky lending practices of Omni National Bank's ("Omni") Community Development Lending Division ("CDLC") during the period of 2005 through 2007 was not sufficiently connected to Omni's decision to hold onto and renovate the collateral for the risky loans—Other Real Estate Owned ("OREO") properties—following the housing crisis. The court therefore determined the retroactive exclusion for prior or "interrelated wrongful acts" did not apply to bar coverage for Omni under a D&O policy. Certain Underwriters at Lloyd's of London v. FDIC, No. 16-16702, 2018 WL 509095 (11th Cir. Jan. 23, 2018).

The unsound lending practices of the CDLC triggered regulatory investigations. When the loans failed, Omni foreclosed on the collateral—the OREO properties—and closed the CDLC in December 2007. Shortly thereafter, certain board members instituted a plan to hold and renovate the OREO properties rather than sell them "as-is" at the time of foreclosure. Omni's regulators approved this plan in 2008, when the bank had a CAMELS rating of 2, which signified Omni was "fundamentally sound." The D&O policy issued by Certain Underwriters at Lloyd's of London ("Underwriters") covered the period of June 2008 to June 2009.

On September 15, 2008, the regulators downgraded Omni's rating, indicating the bank was failing or would fail imminently. The board members nevertheless continued to invest approximately $12.6 million into OREO properties from that date through the Omni's closure in March 2009. The FDIC, as receiver of Omni, settled with the board members responsible for this decision, and brought an action to recover from the D&O policy for what became dubbed the "OREO Wrongful Acts."

Underwriters argued, among other grounds, that the D&O policy did not provide coverage for the OREO Wrongful Acts because the retroactive exclusion for prior or "interrelated wrongful acts" applied. Underwriters said that the OREO Wrongful Acts were interrelated with the CDLC's risky lending practices, also Wrongful Acts. Since the CDLC Wrongful Acts occurred prior to the retroactive date of the Underwriters' D&O policy, there was no coverage for the OREO Wrongful Acts. The court disagreed.

The Eleventh Circuit held that the OREO wrongful acts were for the particular expenditures to rehabilitate OREO properties that occurred after (and only after) Omni received the downgrade to its rating in September 2008. Omni's board authorized these expenditures between September 15, 2008, and March 2009, which the court noted was "clearly within the policy period." The court found that the decision to continue the renovation expenditures occurred after the board knew of Omni's impending failure and "thereby constituted an independent business decision from the initial lending practices in the CDLC division."

© 2018 Aronberg Goldgehn. All rights reserved. The above material is intended for general information and promotional purposes, and should not be relied on or construed as professional advice. Under the Illinois Rules of Professional Conduct, the above information may be considered advertising material. The transmission of this information is not intended to create, and receipt of it does not create, a lawyer-client relationship.

Underwriters could not prove the retroactive exclusion applied because before the downgraded rating signaled the bank's imminent failure, investment in the OREO properties was not a Wrongful Act. Further, Underwriters did not claim, nor did it prove, that the downgraded rating "arose out of" the wrongful acts of the CDLC division. The regulator's decision to downgrade Omni was, in essence, an intervening act that separated the CDLC Wrongful Acts from the OREO Wrongful Acts.

Underwriters relied on the Eleventh Circuit's decision in *Zucker v. U.S. Specialty Insurance* Company, 856 F.3d 1343 (11th Cir. 2017) to argue that the retroactive exclusion applied. As we noted in our newsletter of July 10, 2017 [**CLICK HERE** to view], *Zucker* involved the parent company of a wholly owned subsidiary bank that admitted to engaging in risky lending practices preceding the 2008 housing market crash that rendered it insolvent. Shortly thereafter, the parent obtained a new D&O policy with a prior acts exclusion. In 2009, during the policy period, the parent transferred approximately $46 million to the subsidiary bank to stabilize it. Despite this influx of money, regulators closed the subsidiary bank in May 2009 and appointed the FDIC as the receiver. Creditors sued the parent's board, alleging the $46 million transfer was fraudulent, and the board sought but was denied coverage under the insurance policy's prior acts exclusion.

The *Zucker* court held the prior acts exclusion applied to the fraudulent transfer claim because the parent's insolvency "arose out of" wrongful acts that occurred before the retroactive date and shared a connection with wrongful acts covered by the exclusion. The *Zucker* court found an essential element of the plaintiff's claim, the parent's insolvency, had a connection to some prior wrongful acts of the parent's officers and directors that caused the insolvency, and occurred before the policy's effective date. This holding, Underwriters argued, necessitated the same outcome in this case because the OREO Wrongful Acts necessarily arose from the CDLC Wrongful Acts and were inextricably connected, and thus "interrelated wrongful acts."

The Eleventh Circuit distinguished *Zucker* on the basis that the wrongful acts at issue in *Zucker* were wrongful because the parent company was insolvent at the time they occurred. "The parent company's insolvency was the result of wrongful acts that occurred before the policy period. Thus what ultimately made those transfers wrongful were wrongful acts that occurred before the policy's effective date." The court believed that in Omni's case, however, the OREO Wrongful Acts—the decision to continue funding the OREO renovations in light of the bank's imminent closure—were made during the policy period and were not related to the decisions to make the risky loans in the first place.

Comment

The Eleventh Circuit's decision on the retroactive exclusion, along with its affirmation of the District Court's decision on the inapplicability of other exclusions (e.g., IvI), means that Underwriters is obligated to cover a $10 million stipulated settlement between the FDIC and the members of the board responsible for the OREO Wrongful Acts. The court in this case seemed to draw a line between the actions that set in motion the regulators' decision to downgrade the bank and the decisions made after that downgrade took place. Even though the risky lending practices led to Omni's acquisition of the OREO properties, and even though the decision to renovate the properties was made before the policy period (and the downgrade), the court narrowed in on, and cordoned off, the decision-making of the board following the downgrade to find the exclusion did not apply.

The court specifically noted that Underwriters

failed to argue in its briefing that the "arising out of" language in the policy here excluded the FDIC's claims. Because it raised that contention for the first time at oral argument, the court found the argument to be abandoned. It is unclear whether more emphasis on the broad definition of "arising out of" would have made a difference in the outcome, however, given how strongly the court stressed that the decisions occurring after Omni's downgrade constituted independent business decisions.

If you have any questions about this Update, please contact the author listed below or the Aronberg Goldgehn attorney with whom you normally consult:

Daniel J. Berkowitz
dberkowitz@agdglaw.com
312.755.3167

Christopher J. Bannon • 312.755.3175 • *cbannon@agdglaw.com*
Lisa J. Brodsky • 312.755.3177 • *lbrodsky@agdglaw.com*
Thomas K. Hanekamp • 312.755.3160 • *thanekamp@agdglaw.com*
Catherine Warren • 312.755.3157 • *cwarren@agdglaw.com*
Daniel J. Berkowitz • 312.755.3167 • *dberkowitz@agdglaw.com*
Amber O. LaFevers • 312.755.3170 • *alafevers@agdglaw.com*
Lindsay P. Lollio • 312.755.3171 • *llollio@agdglaw.com*
Danielle L. Rosenberg • 312.755.3172 • drosenberg@*agdglaw.com*
Mark A. Swantek • 312.755.3141 • *mswantek@agdglaw.com*