

# BANK INSURANCE UPDATE

Contemporary Issues For Bank Attorneys

San Francisco Bank Attorneys Association

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## **I. INTRODUCTION**

The case for involvement of attorneys in insurance acquisition and comparative policy evaluations.

### **A. Movement Away From Standardized Forms**

Standardized forms are now the exception and not the rule in the context of D&O insurance and financial institution bonds.

### **B. Availability of New Products and Coverage Enhancements**

Reduced premiums are illusory in relative terms. Banks are finally getting back coverage that was eroded during the bank failure crisis. However, new products and endorsements are creating new opportunities to insure entirely new risks.

## II. APPLICATION ERRORS

### A. Rescission

Those charged with responsibility for application preparation do not always appreciate the consequences of inaccurate applications. They misinterpret the nature of the internal investigation required to meet current legal standards.

Rescission is a strict liability remedy. Non-disclosure of material facts, "whether intentional or unintentional, entitles the injured party to void the contract." **First State Ins. Co. v. Callan Associates, Inc.** 113 F.3d 161 (9th Cir. 1997), quoting, **Montrose Chem. Corp. v. Admiral Ins. Co.**, 10 Cal.4th 645 (1995). Materiality is defined as "the probable and reasonable influence of the facts upon the party to whom the communication is due, in forming his estimate of the disadvantages of the proposed contract, or in making his inquiries." Section 334.

A misrepresentation in an application is ordinarily material as a matter of law. **Imperial Cas. & Indemnity Co. v. Sogomonian**, 198 Cal.App.3d 169 (1988). The test of materiality is based on the subjective effect the truthful answer would have on a particular insurer. *Imperial Cas.*, *supra*. Inquiry into whether the insurer would have refused to provide coverage or would have provided coverage on terms less favorable to the insured had the truthful answer been given is appropriate. **Merced County Mutual Fire Ins. Co. v. California**, 233 Cal.App.3d 765, 772 (1991).

The failure to disclose all prior claims in an application for professional liability insurance has been held a sufficiently material omitted fact to form the basis for rescission. **Mirich v. Underwriters at Lloyd's London**, 64 Cal.App.2d 522 (1944). One case held that the failure to disclose potential lawsuits, including possible wrongful termination suits, was a material misrepresentation as a matter of law. **Jaunich v. National Union Fire Insurance Co.**, et al., 647 F.Supp 209 (N.D. Cal 1986).

A rescission case has been remanded to the District Court for a determination on the merits. **First State**, *supra*. The insured apparently will argue it should have coverage because it maintained continuous D&O coverage and the insurer would have been at the risk even if the disclosures had been made. Although arguably an unfair "Catch-22," similar arguments have been rejected in the context of late reporting. **Insite-Properties, Inc. v. Jay-Phillips Inc.**, 271 N.J. Super. 380 (1994).

## B. Severability Clauses

A handful of bank insurers offer a fail-safe against truly inadvertent non-disclosures.

However, most do not offer this coverage. An inadvertent non-disclosure by one officer in an application for directors' and officers' liability insurance provides a basis for rescission of the policy as to all officers and directors if the policy does not provide for severability. **National Union Fire Ins. Co. of Pittsburgh v. Sahlen**, 807 F.Supp. 743 (S.D.F.Y, 1992), **aff'd** in **National Union Fire Ins. Co. of Pittsburgh v. Sahlen**, 999 F.2d 1532. Severability clauses may be enforced when they are clear. **Wedtech Corp. v. Federal Ins. Co.**, 740 F.Supp. 214 (S.D.N.Y. 1990); **Shapiro v. American Home Assurance Co.**, 616 F.Supp. 900 (D.Mass. 1984).

The availability of liberal severability clauses is one of many examples highlighting the need for policy analysis in comparison shopping for insurance.

### III. REPORTING - YOU SNOOZE YOU LOSE

In the case of both D&O insurance and fidelity bonds the risks associated with tardy reporting are harsh. With one exception noted below, insurers have won every recent California decision dealing with the reporting requirements of liability and property policies.

Yet late reporting continues to be a problem. The consistent excuse seems to be "we thought it would go away" but the sub-rationale is an unwarranted apprehension that the information will be used against the bank in future premium adjustments and renewals. Lawyers on the other hand are often still operating under outdated conceptions that, since California is a "notice-prejudice" state in the general liability policy context, the technicalities of policy reporting provisions are just that.

In the current competitive market, the idea that any advantage is gained by holding back information on potential claims or delayed reporting of actual claims is not supportable. To the extent a claim history has relevance to underwriters in this market, the real consideration is the actual loss experience, i.e., indemnity and defense expense paid out by the insurer. Absent serious financial problems, there is little risk of non-renewal nor that replacement insurance will be unavailable. If the bank is confident no actual claim will be filed or that the claim will be resolved within the deductible, there is no valid reason to hold back on reporting a claim.

#### A. D&O Reporting Requirements

D&O policies like most other E&O policies contain "claims made and reported" provisions. The claim must be both made and reported during the time the policy is effective. Some carriers have definitions of "claim" which require the filing of an actual lawsuit. Otherwise, a simple demand for redress (even with the threat of litigation merely implied) is a claim. **Phoenix Ins. Co. v. Sukut Construction Co.**, 136 Cal.App.3d 673 (1982). However, suits which are extant but neither served nor otherwise known by the insured are not deemed made. **Safeco Surplus v. Employers Reinsurance**, 11 Cal.App.4th 1409 (1992).

Insureds have attempted to argue that notice prejudice rules applicable to occurrence form policies should supersede claims made and reported provisions. The argument has universally failed. **Slater v. LMIC**, 227 Cal.App.3d 828 (1991); **Helfand v. National Union Ins. Co.**, 10 Cal.App.4th 869 (1992).

As noted, despite the arguable inequity, one court ruled it is no excuse that the insured had coverage under successive policies at the time the claim was made and then reported. **Insite-Properties, Inc. v. Jay-Phillips, Inc.**, 271 N.J. Super. 380 (1994). However, a major inequity can occur if the claim is made just before the policy expires. An important feature to look for in the reporting section of the policy is a grace period - hopefully giving the insured at least 30 to 60 extra days to report. See, **Gulf Ins. Co. v. Dolan, Fertig & Curtis**, 433 So.2d 512 (Fla 1983) (grace period not implied).

The courts are generally liberal in construing the adequacy of potential claim notices pursuant to which early reporting will give the bank so-called tail coverage after the policy expires and the claim finally comes along. **FSLIC v. Burdette**, 718 F.Supp 649 (E.D. Tenn 1989).

The recent case of **Continental Ins. Co. v. MGM Inc.**, 107 F.3d 1344 (9th Cir. 1997) is largely consistent with these cases. It held that an early claim notice, that was arguably no more than a laundry list of potential adversaries, satisfied a policy reporting requirement. This was so even though the actual claim was not reported before the policy expired. However, this does not represent a significant in-road into the enforceability of claims made and reporting provisions. In fact, the court expressly acknowledged the authoritative nature of earlier cases.

If anything, **MGM** reinforces the wisdom of tendering early.

## **B. Suit Clauses**

Similar problems arise under the suit clauses of financial institution bonds. Banks are required to file their proof of loss as soon as possible and when that is done, policy suit clauses will be tolled until the claim is declined. **Stanton Road Associates v. Pacific Employers Ins. Co.**, 36 Cal.App.4th 333 (1995). Otherwise the insured must file suit to recover the loss within two years of discovery of the loss. **USLIFE Savings & Loan Assoc. v. National Surety Corp.**, 115 Cal.App.3d 336, 346 (1981). Two recent property insurance cases have rejected one of the most common excuses banks have relied upon for late reporting - that loss in excess of the deductible was belatedly discovered. **Sullivan v. Allstate Ins. Co.**, 946 F.Supp. 1407, 1413 (C.D. Cal 1997); **Hill v. Allstate Ins. Co.**, 962 F.Supp. 1244 (C.D. Cal 1997).

#### IV. ALLOCATION AND RECOUPMENT

##### A. Current Law of Allocation

There are four variables which come into play in the area of allocation:

1. Covered Versus Uncovered Parties
2. Covered Versus Uncovered Claims
3. Defense Expense
4. Settlement

In late 1995, the definitive decision on directors and officers liability and allocation law was decided in the case of **Safeway Stores Inc. v. National Union**, 64 App.3d 1282 (9th Cir. 1995) The **Safeway Stores** case held that, under California law, allocation of attorneys fees would be resolved according to the "reasonably related" test. The Court imposed a duty on the insurer to establish that fees incurred in the joint defense of the company and the insured officers or directors would not have been incurred but for counsel's representation of the uninsured entity. Earlier this year, in the case of **Buss v. Superior Court**, 16 Cal.4th 35 (1997) the Supreme Court adopted substantially the same rule with respect to covered and uncovered claims within the same lawsuit.

A number of commentators have adopted a simplistic but likely erroneous interpretation of **Safeway Stores** on the issue of allocation of settlements. Many interpret the case as holding the ability to allocate turns on the absence or presence of vicarious liability. That interpretation is likely traceable to the fact that **Safeway Stores** and predecessor Ninth Circuit case, **Nordstrom, Inc. v. Chubby Sons, Inc.**, 54 F.3d 1424 (9th Cir. 1995) (applying Washington law) were securities fraud cases. Under Section 10(b), the issuer is strictly liable under vicarious liability principles for all misrepresentations of the insured officers. D&O claims in other areas of tort and contract law rarely present such relatively straightforward and simple alignments of liability risk.

If one adopts this interpretation of **Safeway Stores**, the outcome would actually be unfavorable to the uninsured bank in many contexts. In a large percentage of cases a bank's

liability to customers or others is direct not derivative. By definition, vicarious liability involves liability on the part of the principal for which the agent could also be sued. 2 Cal.Jur.3d §§ 135, 136.

Under California law, bank officer's acting within the scope of their normal duties have no direct duty of care to bank customers and others with whom they deal on behalf of the bank. See, **Grosvenor Properties, Ltd. v. Southmark Corp.**, 896 F.2d 1149, (9th Cir. 1990). **United States Liability Insurance Company v. Haidinger-Hayes, Inc.** 1 Cal.3d 586 (1970). This doctrine has been applied in the context of misrepresentation claims (**Self-Insurer Security Fund v. ESIS, Inc.**, 204 Cal.App.3d 1148 (1988)), investment fraud claims (**Schwartz v. Pillsbury, Inc.**, 969 F.2d 840 (9th Cir. 1992)) and lender liability claims (**Black v. Bank of America**, 30 Cal.App.4th 1 (1994)).

In fact, the **Safeway** court adopted the so called "larger settlement rule" from the leading case of **Harbor Insurance Company v. Continental Bank Corp.**, 922 F.2d 357 (7th Circuit 1990). Under the larger settlement rule, a directors and officers liability insurer must indemnify the full amount of any settlement of a covered claims unless it can establish a portion of such settlement is allocable to an enhanced risk of liability traceable to the uninsured entity. See also, **Raychem Corp. v. Federal Ins. Co.**, 853 F.Supp. 1170, 1182-83 (N.D. Cal 1994).

The **Safeway Stores** court held that allocation principles apply where it can be established that a corporation's potential liability increases the amount of the settlement:

- (1) If the corporation is exposed to liability for which the directors and officers lack responsibility;

or,

- (2) If, notwithstanding the potential for joint liability, the presence of the corporation as a defendant increases the amount of loss the insurer would otherwise be legally obligated to pay.

64 F.3d at 1288. Under the foregoing standard a more critical comparative liability evaluation is required determining whether vicarious liability principles apply. Thus some have concluded that allocation is a dead issue in California because corporations virtually always act through their senior management. That view appears unwarranted and fails to take into account the limits on the vicarious liability doctrine.

## **B. Allocation Provisions**

Before Safeway Stores was ever decided most carriers endeavored to "contract around" the larger settlement rule with allocation provisions. The popular methods are as follows:

### **1. Best Efforts Provisions**

In Safeway Stores, National Union argued that an allocation was appropriate because its policy also in fact contained an allocation provision. The National Union policy directed that the company and insured engage in negotiations to determine a fair and proper allocation. 64 F.3d at 1289. The Court of Appeals agreed with the lower court's conclusion that although such a provision established a procedure for an allocation, it failed to define a standard:

The District Court determined that the clause "required an allocation analysis", but not necessary an allocation. This reading comports with the policy language. 64 F.3d at 1289.

Thus "best efforts" and "reasonable allocation" provisions have no real effect unless an allocation is appropriate under state law.

### **2. Relative Exposure Provisions**

The AIG Companies developed an alternative clause which provides for an evaluation of the "relative exposure" of the parties under comparative fault principles. This approach is drawn from Nodaway Valley Bank v. Continental Casualty Company, 916 F.2d 1362 (8th Cir. 1990). Under Nodaway both fees and settlement are allocated according to the relative exposure of the insured and uninsured defendants. For example, if both insured and uninsured defendant face equal exposure to liability, both defense costs and settlement would also be shared equally. There are no published cases interpreting such provisions as of yet.

### **3. Fixed Percentages**

Pre-set allocation endorsements are especially popular in the case of securities fraud claims. There are no published cases interpreting these endorsements as of yet.

#### 4. Separate Counsel

Since D&O insurers normally have approval authority over retention of counsel some may seek to avoid disputes over allocation by refusing to consent to joint representation. Because of nascent conflicts based on indemnity and contribution issues and the practical fact that separate settlements are often cheaper than global settlements, such refusals may be justifiable. We know of no decisions on this subject.

#### C. Recoupment

Two recent decisions in combination may provide hidden risks to insureds.

Until recently, there was a view that unless an insurer expressly cited a potential policy defense in its reservation of rights, such policy defenses would be deemed waived. There was a split of authority in California with one line of authority suggesting that, if an insured failed to overtly preserve to policy defense, it would be forever lost. See e.g., McClaughlin v. Connecticut General Life Insurance Company, 565 F.Supp 434 (N.D. Cal. 1983).

In Waller v. Truck Insurance Exchange, 11 Cal.4th 1, 32-33 (1997) the California Supreme Court expressly followed the competing line of authority from sister states and rejected the McClaughlin approach. Waller holds that waiver cannot be found through mere silence such as a failure to cite a policy defense in a declination letter. Rather, in order to find waiver it must be established that the insurer affirmatively expressed an intent to waive a policy defense.

Before the Buss decision it was common to obtain a so-called Johaansen agreement to assure that the advancement of defense expense and settlement payments did not constitute a waiver of the right to seek recoupment if coverage were subsequently disproved in a coverage action. Buss holds that in order to preserve a right of recoupment the insurer need only reserve rights. 16 Cal.4th at 47.

In combination, Waller and Buss create the potential that insureds will be blindsided by post-settlement recoupment actions they have not adequately anticipated and may have materially affected how they would have viewed a settlement. Johaansen agreements kept this issue above board and in the forefront. Thus liability settlements were usually coupled with insurer-insured releases.

Given the new liability afforded to late coverage defenses the bank's counsel should secure written waivers as to recoupment claims at the time the liability case is resolved.

## V. D&O COVERAGE ENHANCEMENTS

### A. Lender Liability

#### 1. Not a Dead Tort

Lender liability is an area which illustrates that published decisions are not always a reliable indicator of a bank's liability risk.

The various favorable decisions since the demise of the Commercial Cotton doctrine do not create a completely seamless web. The cases generally state their own limitations and exceptions. Those exceptions often serve only to catalyze the creative energies of the borrower's counsel to plead around parol evidence and statute of fraud problems. Having lost their livelihood or a major business opportunity, borrowers are often bitter and willing to go along with the program of selective recall to extract what they perceive as just compensation. Finally, lower court judges are often uncomfortable with the existing decisions viewing them as unduly protective of banks, especially in cases of undue hardship to the borrower. Many cases which appear on paper to be unassailable candidates for early dismissal ultimately drift into a morass of undecisive pleading battles and credibility disputes.

Some of the more common ploys to dodge early dismissal motions are as follows:

#### a. Parol Evidence Rule

Claims of misrepresentation cannot contradict express terms of contract. Price v. Wells Fargo Bank, 213 Cal.App.3d 465 (1989). However, "simply being at odds" with factual assertions in the contract is not a direct contradiction. Airs, Inc. v. Perfect Scents Ltd., 902 F.Supp. 1141, 1147 (N.D. Cal. 1995) (also contradicts Price on efficacy of integration clause).

#### b. Statute of Frauds

Promissory estoppel claims at variance with express agreement are not permitted. **Owens v. Foundation for Ocean Research**, 107 Cal.App.3d 179 (1980). However, not all agreements are governed by the statute. **Landes Coast Co. v. Royal Bank of Canada**, 833 F.2d 1365 (1987). Relief granted for unconscionable injury. **Tenzer v. Superscope, Inc.**, 39 Cal.3d 18 (1985).

### c. Breach of Fiduciary Duty

A bank is generally not a fiduciary of a loan customer. **Price**, supra, 213 Cal.App.3d at 476; **Kim v. Sumitomo Bank of California**, 17 Cal.App.4th 974 (1993) However, borrowers often succeed in arguing fiduciary relationship is a question of fact. **In re Daisy Systems Corp.**, 97 F.3d 1171 (9th Cir. 1996). **Michelson v. Hamada**, 29 Cal.App.4th 1566 (1994) Cf., **La Monte v. Sanwa Bank California**, 45 Cal.App.4th 509, 517 (1996).

### d. Negligence

Negligent performance of contract is not a tort. **Kim**, supra. However, breach of duty growing out of the contract is a tort and grounds for negligence liability. **North American Clinical Co. v. Trans Harbor, Inc.**, 97 DAR 14517 (1997).

### e. Frustrated Borrowers

Those turned away after alleged oral commitments are made evade statute of frauds problems by suing for fraud. **Texaco, Inc. v. Ponsaltdt**, 939 F.2d 794 (9th Cir. 1991).

### f. Guarantors

Guarantors often claim important terms and risks are concealed. **Sumitomo Bank v. Iwasaki**, 70 Cal.2d 81 (1968). Although **Iwasaki** outlines paternalistic duties reminiscent of **Commercial Cotton**, the Supreme Court has had no opportunity to re-visit the case.

## 2. Rationale for Entity Coverage for Lender Liability

Entity coverage should be considered for two reasons. First, a contractual liability of the bank is involved making the bank the most obvious and easy target. Plaintiffs often omit claims against insured officers and directors.

Second, as non-contracting parties, officers have much better threshold defenses than the bank in light of the **Haidinger-Hayes** doctrine, supra. Thus, officers obtain early dismissal more often than the bank.

### **3. Regulatory Endorsements**

Entire seminars were devoted to coverage for regulatory actions and carriers quickly moved to exclude regulatory claims. In the current market, such exclusions are being replaced by regulatory endorsements. Provided the bank has a reasonable CAML rating, most carriers will provide the coverage without a surcharge.

### **4. Public Policy Issues With Regulatory Coverage**

Regulatory coverage is critical because the regulators frequently allow more liberal insurance coverage than they do indemnification. The following is a summary of the competing treatment of indemnification versus insurance.

#### **a. National Bank Act**

Banks are entitled to track the indemnification provisions of state law where the bank's holding company is incorporated. However, by regulation, the OCC prohibits indemnification of civil penalties assessed by a regulatory agency and/or restitution and disgorgement payments to the bank itself by order of the regulatory agency. 12 CFR 7.5217. This includes associated expenses. The regulation also dictates that insurance not be purchased nor available for civil money penalties. However, there is no prohibition respecting insurance of defense expense.

#### **b. FIRREA**

Indemnification is allowed under FIRREA where the director or officer prevails on the merits. 12 CFR § 545.121. In the absence of a favorable judgment on the merits, indemnification is allowed if a majority of disinterested directors conclude that the officer was acting in good faith, within the reasonably perceived scope of his employment and based on a reasonable belief that the officer was acting in the interest of the bank. A 60 day advance notice to the OTS is applicable. Id.

Advancement agreements on defense expense and settlements are allowed by majority vote of the board. However, an express undertaking guarantee must be executed by the director or officer in the event indemnification is not permitted.

Insurance may be purchased but payment for willful or criminal misconduct is prohibited. 12 CFR § 545.121(d). It is not particularly clear how this regulation meshes with

public policy limitations of state law but it appears more restrictive. In all likelihood "willful" excludes negligence and gross negligence but not necessarily reckless violations of FIRREA.

### c. **Crime Control Act**

Under 23 U.S.C. 1828, the FDIC can set aside golden parachute or indemnification agreements in favor of insiders that it finds to be a fault for the precarious financial condition of the bank. See, e.g., **Howell v. FDIC**, 986 F.2d 572 (1st Cir. 1993). Restrictions on insurance are not proscribed.

## B. **Employment Practices Liability**

The critical question most banks have respecting EPL coverage is whether the policies are of any value in light of public policy constraints.

### 1. **Summary of Existing Law**

Section 533 excludes "indemnification of wilful conduct but not the defense of an action in which such conduct is alleged." **B&E Convalescent Center v. State Compensation Ins. Fund**, 8 Cal.App.4th 78, 93 (1992). Whether a liability policy affords a defense or defense funding for allegations of uninsurable conduct depends on: (1) Whether the allegations create the potential of insurable damages, and (2) the reasonable expectations created by the policy language. Id. at 93, 99-101.

Not all wrongful termination claims and discrimination claims are uninsurable. Such claims are uninsurable when they cannot succeed in the absence of proof of intentionally committed conduct that is inherently wrongful. Id. at 95-98. Racial and sexual discrimination violates California's Fair Employment and Housing Act. Because the conduct is inherently wrongful and because it violates fundamental public policies against discrimination, the **B&E** court found all terminations based on race or sex uninsurable. Id. at 98.

The **B&E** court referred to such wrongful termination claims involving public policy violations as "**Tameny**" claims based on the Supreme Court case in **Tameny v. ARCO**, 27 Cal.3d 167 (1980). 8 Cal.App.4th at 92-93. In essence, because of the scope of preemptive California workers compensation law and a general prohibition against tort liability based on wrongful termination in California for at-will employees, plaintiffs must plead fairly extreme conduct to make a case for wrongful termination. Although some types of discrimination do not

fall within the ambit of Section 533, a large proportion of the wrongful termination claims being filed at this time are **Tameny** claims.

Examples include:

**a. Discrimination and Harassment**

Such claims are generally uninsurable. **Coit Drapery Cleaners, Inc. v. Sequoia Insurance Company**, 14 Cal.App.4th 1595 (1993)

**b. Disparate Impact and Treatment**

Note the courts distinguish between disparate impact claims and disparate treatment claims. Disparate impact does not require proof of intent to discriminate and is thus insurable. **Savemart Supermarkets, Inc. v. Underwriters at Lloyds**, 843 F.Supp. 597 (N.D. Cal 1994). Disparate treatment claims are by their nature deliberate, and thus are uninsurable **American Guaranty & Liability v. Vista Medical Supply**, 699 F.Supp. 787 (N.D. Cal 1988).

**c. Covered and Uncovered Claims**

Relying on **Horace Mann Ins. Co. v. Barbara B.**, 4 Cal.4th 1076, 1084 (1993) many carriers will deny coverage for actions involving defamation, invasion of privacy and other torts which would otherwise fall within coverage on the grounds that the conduct are "inseparably intertwined" with unsuitable conduct. See, *Jane D. v. Ordinary Mutual*, 32 Cal.App.4th, 643, 652-53 (1995). The test itself is rather ambiguous. In addition, recent cases espousing that harassment or discrimination claims tainted all other tort claims were ordered unpublished. **Moore v. Continental Ins. Co.**, 44 Cal.App.4th 10 (1996); **Fire Ins. Exchange v. Superior Court**, 12 Cal.App.4th 457 (1993). The more conservative approach is to defend. **American Guaranty & Liability v. Vista Medical Supply**, 699 F.Supp. 787 (N.D. Cal. 1988).

**d. Fraud Claims**

A narrow exception to the **Tameny** rules was recognized in **Lazar v. Superior Court**, 12 Cal.4th 643 (1996) which recognized promissory fraud may suffice as a ground for wrongful termination. Since promissory fraud involves both intentional misrepresentation and an intent to mislead the victim, **Lazar** claims are likely uninsurable. 12 Cal.4th at 638; Civ. Code § 1710(4).

**e. Other Claims**

Keep in mind that the rule is not limited to harassment or discrimination. Any wrongful termination claim which asserts a public policy violation will likely be uninsurable. Examples include retaliatory firings based on union activities, political activities, whistleblowing, etc.

**2. Exceptions Providing Opportunities for Coverage**

**a. Defense Costs**

The **B&E** court expressly recognized that public policy would not prohibit the defense of legitimately disputed claims 8 Cal.App.4th at 101. See Also, **Republic Indemnity Co. v. Superior Court**, 224 Cal.App.3d 492 (1990).

**b. Settlement**

No California court has addressed the insurability of settlements where the carrier expressly agreed to provide discrimination or other employment practices coverage. By analogy courts which have considered settlements of potentially unindemnifiable securities fraud claims have found no public policy problems. Competing public policy favoring the voluntary settlement of disputed claims allow for the indemnification and insurability of such settlements. **Raychem Corp. v. Federal Ins. Co.**, 853 F.Supp. 1170 (N.D. Cal 1994). **Weinberger v. Bankston**, Fed. Sec. L.Rptr. (CCH) [1987-88 Transfer Binder] & 93,539 p. 97,416 (Del. Chan. 1987).

**c. Indemnification of Innocent Employer**

A California case addressed this issue in the context of sexual discrimination claims (brought under FEHA) under a general liability insurance policy that covered discrimination as a type of personal injury. The court in **Melugin v. Zurich Canada**, 50 Cal.App.4th 658 (1996) concluded that § 533 does not relieve an insurer of its defense obligations for discrimination claims. The court distinguished **Coit** because it did not involve an insurer that had specifically granted coverage for discrimination claims and then sought to disavow coverage. In addition, by negative inference, **Coit** suggests unratified misconduct and negligent supervision of the officer could fall within coverage. 14 Cal.App.4th at 1605.

Thus, the **Melugin** court also noted that only a portion of the allegations in the complaint disclosed potential liability which would not be precluded from coverage by § 533. Some of the FEHA violations alleged against the employer, Canada Life, sounded in strict liability or respondeat superior. Thus, even if Canada Life were found liable for its own intentional conduct (if it were found to have ratified Melugin's conduct), it could also be held liable for non-intentional conduct under either of these doctrines. In either case, the claim would not be precluded by § 533.

The foregoing suggests a potential trend under which courts will exercise increased tolerance of voluntary insurance for these highly prevalent claims. If the courts fail to adopt more liberal standards on indemnification and insurance, it will have an inevitable chilling effect on contesting such claims, many of which are legitimately disputed.

### **3. Conflicts for Bank's Counsel**

The public policy problems surrounding indemnification and insurance of employment claims raise difficult issues for attorneys retained to represent the bank and the accused officer. Although a united front is desirable, bank and officer have conflicting interests.

The bank will often want to take a firm stance to discourage copycat claims. However, in the event of an unfavorable judgment the officer will face uninsured and unindemnifiable liability. Thus a united front may place the officer's personal assets at risk.

These issues need to be discussed early in the engagement. Counsel should evaluate and address with both clients the separate risk and separate settlement opportunities of the officer whether this suits the bank's objectives or not. If the conflicts reach the point where a joint strategy appears untenable, the officer should obtain separate representation.

#### **C. Securities Liability**

##### **1. Scope of Coverage**

D&O carriers have normally never excluded coverage except in the case of short swing profit and insider trading claims. The movement has been toward entity coverage or defining the scope of entity coverage with pre-set allocation provisions.

##### **2. Liability Developments and Public Policy Issues**

###### **a. Federal Law**

The proscriptions on indemnification of securities fraud claims under federal law do not preempt more permissive state indemnification statutes. **Baker, Watts & Co. v. Miles &**

**Stockbridge**, 876 F.2d 1101 (4th Cir. 1989); **Raychem v. Federal Ins. Co.**, 853 F.Supp. 1170, 1178-80 (N.D. Cal. 1994). Further, the SEC itself has issued a release suggesting approval of the purchase of liability insurance covering securities claims. 17 CFR § 230.461(c).

Moreover, settlements versus actual judgments based on adjudicated fraud are generally indemnifiable and insurable. **Raychem**, *supra*. **Weinberger v. Bankston**, Fed. Sec. L.Rptr. (CCH) [1987-88 Transfer Binder] & 93,539 p. 97,416 (Del. Chan. 1987). Thus the CFTC, as an assignee under a liability policy, recently convinced a court that there was no public policy problem with its recovery of a \$200,000 fine because the recovery was based on a consent decree. **CFTC v. Kemper Financial Services, Inc.**, 1996 U.S. Dist. LEXIS 5359 (N.D. Ill. 1996) See also, **Cambridge Fund, Inc. v. Abella**, 501 F.Supp. 598 (S.D.N.Y. 1980).

The insurance industry is closely watching the Ninth Circuit's review of **In Re Silicon Graphics, Inc. Sec. Lit**, 970 F.Supp. 746 (N. D. Cal. 1997) (conscious behavior giving rise to strong inference of fraud must be pled) and Judge Smith's articulation of the pleading and proof requirements of the Reform Act. Critics claim that Judge Smith's interpretation of the scienter requirements is so exacting that Section 10(b) liability will become an utterly useless and defunct remedy. Insurers are wondering whether the scienter actually required is mutually exclusive of that which is insurable under Section 533 of the Insurance Code. Thus the court in **Raychem** made much of the fact that mere reckless violations could support liability under pre-Reform Act law.

### 3. State Law Developments and Public Policy Issues

Issuer fraud is clearly insurable under California law as mere negligent misrepresentation can support liability. **Bowden v. Robinson**, 67 Cal.App.3d. 705 (1997). *But see*, **Employers Ins. of Wausau v. Musick, Peeler & Garrett**, 948 F.Supp. 942 (S.D. Cal. 1995) (suggesting all forms of fraud uninsurable).

However, aider claims based on which lenders are sometimes ensnared require proof of "intent to deceive." Cal. Corp. Code § 25504.1. This is a different standard than that identified for uninsurability in **Raychem**. Relying on **Clemmer v. Hartford Ins. Co.**, 22 Cal.3d 865, 887 (1978), Judge White ruled that a "preconceived design to inflict injury" had to be established in fact. This is an inaccurate and incomplete articulation of the test. Since the Supreme Court's decision in **J. C. Penney Cas. Ins. Co. v. M.K.**, 52 Cal.3d 1009 (1991), Section 533 has been broadly construed to cover inherently harmful conduct. **Aetna Cas. & Surety Co. v. Sheft**, 989 F.2d 1105 (9th Cir. 1993) (intentional fraud); **Aetna Cas. & Surety Co. v. Superior Court**, 19 Cal.App.4th 320 (1993) (patent infringement). Thus aider liability is likely unindemnifiable and uninsurable.

As in the case of federal law, all eyes are currently on a pending case. The Supreme Court recently granted review of **Diamond Multimedia v. Superior Court**, 97 D.A.R. 4021 (1997) a case which will test the jurisdictional limits of the anti-fraud provisions of California Corporate Securities Law of 1968. Plaintiffs hope to evade the constraints of the Reform Act by certifying nationwide classes of secondary market investors in state court.

The federal district courts have uniformly relied on certain restrictions in the statutes to hold that only IPOs of California-based companies qualify for nationwide class certification. **In Re Victor Technologies Sec. Lit.**, 102 F.R.D. 53, 60 (N.D. Cal. 1984); **Weinberger v. Jackson**, 102 F.R.D. 839, 847 (N.D. Cal. 1984).

The plaintiffs' class action attorneys unsuccessfully tried to write this restrictive language out of existing law when it proposed Proposition 211. In all likelihood the Court will be barraged with amicus briefs from companies claiming they will leave California if nationwide classes are certified. The potential unbalanced impact on local companies is an issue which will be difficult for the Court to ignore. Thus exercising jurisdiction over out-of-state companies could raise constitutional problems. **Phillips Petroleum v. Shutts**, 472 U.S. 797 (1985).

## VI. BOND COVERAGE ENHANCEMENTS

### A. Negligent Operations Riders

Traditionally, bankers blanket bonds were designed to cover robbery, forgery and other crime losses for which no failsafe security measures were possible. A hackneyed interpretive principle is that bonds never cover loss stemming from a bank's failure to follow commercially reasonable operating procedures. E.g., **French American Banking v. Flota Mercante Grancolombiana, N.A.**, 752 F.Supp. 83, 94 (S.D.N.Y. 1990).

However, competitive pressures have led to the development of new riders which unquestionably provide coverage for mere negligence. Examples include:

1. Unauthorized Signature Rider;
2. Stop Payment Liability Rider;
3. Check Kiting Rider.

### B. Treasury Check Rider

Treasury checks present special risks for depository banks because in the case of alterations the deck is stacked in favor of the Treasury.

Under Circular 21 the Treasury is not subject to the U.C.C.'s midnight deadline rules. Instead, the Federal Reserve Bank only extends "immediate credit" to member depository banks before the Treasury has completed its "first examination." 31 CFR §240.3(c)(d); 12 CFR § 210.10(a); Operating Circular 1, Section 8, Time Schedules and Availability of Credit. Such immediate credit is "subject to payment of actually and finally collected funds, for government checks." Circular 1, *supra*, Appendix 24.4; See, 12 CFR § 210.13 (Reserve Bank can reverse credit on any transaction where it fails to receive "actually and finally collected funds").

The Treasury has a "reasonable time" within which to complete its first examination.

In practical fact the Treasury can take weeks and even months to issue a declination notice on a bad check. Under its own internal guidelines it contends there is no absolute limit on the meaning of "reasonable time" short of the applicable one-year statute of limitations.

Yet Regulation CC recognizes no exception for the depository bank, a Catch 22. It must allow withdrawals notwithstanding that it merely has a provisional credit at the Federal Reserve Bank pending the first examination.

Notwithstanding the Treasury's EFT99 initiative, millions are being lost to offshore crime rings. One bank which lost \$1.6 million on a counterfeit check took the Treasury to task. It convinced the court to construe the declination provisions narrowly. Thus the court never reached the question of whether a 7 month delay in conducting a first examination was reasonable. See, **ABN AMRO Bank, Inc. v. United States**, 34 Fed. Cl. 126 (1995).

Sureties are aware of this risk. Almost none are willing to write treasury check coverage because of the open-ended risk involved and their historical unwillingness to underwrite even short-term provisional credit transactions. Most bankers never consider that Exclusion O of Form 24 excludes this risk until they face their first major loss. See, **Mitsui Mfg. Bank v. Federal Ins. Co.**, 795 F.2d 827 (9th Cir. 1986).

Thus treasury check coverage is valuable if you can find the few sureties which offer the rider.

### **C. Court Costs and Attorneys Fees Rider**

Most sureties provided this rider at one point. However, it was eliminated based on unfavorable loss experience, numerous coverage disputes and cases such as **Downey Savings & Loan Assn. v. Ohio Cas. Ins. Co.**, 189 Cal.App.3d 1072 (1987) which approached construing the coverage as akin to duty to defend coverage.

Bancinsure and St. Paul have reinstated this coverage without any premium surcharge. Brokers selling competing bonds will argue that the rider adds little of value for most covered losses, which is in fact true. The UCC and clearinghouse rules have a fairly well-defined loss distribution scheme for most losses. Most claims are settled with little or no defense expense.

However, good risk management dictates that frequency of loss be balanced against the severity of loss associated with peculiar risks. Notwithstanding the emphasis on the displacement doctrine in the 1992 revisions to the Code, we continue to see high defense expense experience in certain areas.

#### **1. Fiduciary Accounts**

There is some good recent authority in this area. **La Monte v. Sanwa Bank California**, 45 Cal.App.4th 509 (1996). However, the fact remains that the controlling principles of knowledge or notice are highly factual. Cal. Com. Code § 3307. After lengthy discovery, these cases often devolve into credibility disputes. The victim's counsel will seek to manipulate a bank officer's basic familiarity with the account, coupled with adherence to normal procedures respecting large items, to espouse a virtual conspiracy to help the dishonest trustee.

## 2. Employee Embezzlement

Courts often get hung up on factual disputes over the dishonest employee's authority to sign, endorse or otherwise conduct transactions for the principal. E.g., **Spear v. Wells Fargo Bank**, 130 F.3d 857 (9th Cir. 1997); **Oswald Machine and Equipment v. Yip**, 10 Cal.App.4th 1238 (1992). In addition, many claims are legitimately worth fighting under apparent and ostensible agency principles and comparative fault principles where they apply.

## 3. Displacement

Attorneys who handle a large volume of UCC cases will acknowledge that many judges do not understand displacement. Even more often they see the doctrine as unfairly protective of banks and creditors. E.g., **Knox v. Phoenix Leasing, Inc.**, 29 Cal.App.4th 1357 (1994).

### D. High Tech Riders and Coverages

Standard financial institution bonds are poorly suited for electronic funds transactions because the focal point of most coverages is the authenticity of tangible negotiable instruments and documents of title.

Many merchants are now using the "paperless" Corporate Trade Exchange ("CTE") options available through the ACH. The depositor, aka "Originator", signs a general agreement with its ACH member depository bank ("ODFI") preauthorizing certain debit and credit transactions with the depositor's customers.

Perhaps the depositor's original agreement is akin to a draft and perhaps transactions initiated by the customer are like a demand draft notwithstanding that the entire transaction may be electronically initiated and recorded. See, e.g., **Richards v. Platte Valley Bank**, 866 F.2d 1576 (10th Cir. 1989) (check can be broadly construed to include wire transfer under UFA); **Lignoul v. Continental Illinois Nat. Bank & Trust Co.**, 536 F.2d 176 (7th Cir. 1976) (EFT through computer terminal equivalent of check). See Cal. Com. Code § 3104(k).

We also have no problem concluding that PIN numbers and other electronic security measures serve the same authentication objective as handwritten or mechanically produced signatures.

However, the key fraudulent methodologies covered by a bond, i.e., forgery, counterfeit and alteration are completely misdescriptive of the normal sources of EFT losses. Losses are generally better characterized as imposter, interloper and false pretenses losses which bonds generally only cover when the perpetrator is on premises. **Oritani Sav. & Loan Assoc. v. Fid. & Deposit of Maryland**, 989 F.2d 635 (3rd Cir. 1993)

We know of no comprehensive study by the surety industry. It seems to be taking pot shots at electronic funds losses through certain narrow and specialized forms. Commonly understood loss sources such as credit cards, ATMs or computer tampering by a hacker have been the focus. Common forms include:

- a. Plastic card crime policies
- b. Computer crime policies

However, insurers also require meaningful loss experience data to credibly underwrite losses. With the possible exception of CBA's 1994 fraud survey, the industry has made almost no effort to classify the popular methodologies pursuant to which electronic losses are most frequently perpetrated nor to quantify those losses. Thus most either information on electronic losses is anecdotal and, as such, an unreliable basis for effective risk management and underwriting.

## VII. MISCELLANEOUS RECENT DECISIONS

### A. Bad Faith

The Supreme Court has accepted review of **Kransco v. Am-Empire Surplus Lines Co.**, 63 Cal.Rptr.2d 532 (1997) in order to resolve the conflict over whether comparative bad faith is a legitimate tort. Note the **Kransco** court ruled an insured's bad faith could support contract claims and defenses under the cooperation clause. The advantage of comparative bad faith is that it allows apportionment of fault between an insurer and the insured when both are partially responsible for a bad result.

### B. Pollution Coverage

#### 1. Site Investigation Expense

The Supreme Court's decision in **Aerojet-General Corp. v. Transport Indemnity Co.**, 17 Cal.4th 38 (1997) was a major blow to primary insurers who believed **AIU Ins. Co. v. Superior Court**, 51 Cal.3d 807 (1990) had been clear in identifying site investigation costs as an indemnity obligation. The court called this rule a rebuttable presumption, noting that responses to RI/FS orders, private claims, etc. were more akin to defense expense. Since the court recognized that defense and indemnity are mutually exclusive, when RI/FS directives are rolled into a final order and thus become response costs, they presumably become indemnity expense.

A problem for insureds is the fact that only post-tender investigation costs are covered. Some insureds sued after incurring substantial expense and never went through the formality of tendering.

The excess carriers also received another benefit. The court reaffirmed earlier rulings that excess carriers have no duty to defend until primary insurance and self-insured retentions are exhausted. (Footnote 21)

The fronting aspect of the decision is hard to defend. The Court equated fronting with self-insurance which it is not in the many cases where the insured does not in fact cede the loss back to itself.

#### 2. Horizontal Versus Vertical Exhaustion

The Court continues to duck opportunities to address this question. However, its comments in footnote 21 and its discussion of equitable apportionment of loss among insurers at

the same level suggests it would favor the mechanical exhaustion of policies layer by layer in continuing trigger cases.

### **3. Pollution Exclusion Found Ambiguous**

Although applying Montana law, Enron Oil Trading Co. v. Walbrook Ins. Co., 97 C.D.O.S. 9608 (1/23/97) is troublesome as a Ninth Circuit case. Montana law on ambiguities is similar to California law. The court found the term "contamination" ambiguous. This is a term used in the absolute pollution exclusion.

### **4. PRP Letters and Cleanup Orders**

The Supreme Court has accepted review of a case dealing with the meaning of "suit" to resolve the question whether administrative orders and PRP letters constitute suits triggering a duty to defend. Compare, Foster-Gardner, Inc. v. National Union Fire Ins. Co., 56 Cal.App.4th 204 (1997); Fireman's Fund Ins. Co. v. Superior Court, 57 Cal.App.4th 1252 (1997).

### **5. Sudden and Accidental - Burden Shifts on Summary Judgment**

When the duty to defend is at stake, the burden shifts on summary judgment for the insurer to prove no sudden and accidental event. A-H Plating v. American Nat. Fire Ins., 57 Cal.App.4th 427 (1997).