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Don't Let Insurers Leave Your Bank Holding Bag in Overdraft Cases

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Banking institutions pay substantial premiums to insurance companies for professional liability insurance policies, including coverage modeled after directors and officers (D&O) and errors and omissions (E&O) liability policies. The insurance companies have no problem collecting these premiums, but all too often, they balk when it comes time to indemnify their bank policyholders for the settlement of underlying claims against the bank. The insurance companies' failure to pay appears to be happening in connection with the recent settlements by major retail banks involved in the overdraft fee litigation.

Over the past few years, lawsuits have been filed against nearly every significant retail bank over the way that banks calculate and assess overdraft fees. In most of these cases, the customer agreements permitted the banks' method for calculating the fees, the fees and methods were disclosed to the banks' customers, and most importantly, the fee calculation approach was approved by government regulators. Nevertheless, many of the banks have decided to settle these lawsuits for cents on the dollar in order to eliminate the cost of defending against them and to obtain certainty regarding the outcome.

Bankers' professional liability insurance policies almost universally exclude coverage for intentionally dishonest, fraudulent or criminal acts and for ill-gotten gains, but often premise those exclusions on a "final adjudication." Indeed, because these fraud exclusions are premised on a judicial adjudication, the policyholder theoretically can settle an underlying suit alleging fraud or dishonesty (consistent with the cooperation clause in the policy) and avoid the applicability of the exclusion.

Despite the fact that the parties to the insurance contract agreed that coverage is excluded only where there is a judicial determination of actual wrongdoing, insurance companies frequently take the position that there is no coverage for the settlement of underlying claims that seek the return of certain banking fees, such as in these overdraft fee cases. Insurance companies generally argue that allowing banks to receive coverage for fees returned via an overdraft settlement violates public policy and rewards supposed wrongdoing. However, there is typically no exclusion in the policy that justifies such an outcome, especially where the bank resolves the underlying litigation via a reasonable settlement. Instead, insurance companies reference general, limiting language in the definitions section such as "matters which are uninsurable under the law" and public policy arguments against insurance recovery for restitutionary loss or disgorgement.

Not only does this argument ignore the express terms of the insurance contract – which premise the fraud exclusion on a final adjudication, as opposed to a settlement – but it also thwarts the core value of bankers professional liability coverage, since most customer claims against a bank seek the return of certain bank fees as a measure of damages or equitable relief. To the extent that banks engaged in business practices that not only were well-known (by underwriters) and common across the industry, but also were approved by regulators, claims surrounding such practices – including the settlement of such claims – should not be excluded.

Another argument in favor of coverage involves a bad faith claim against the insurance company for failure to settle within limits when there is a reasonable opportunity to do so and a substantial likelihood of a judgment against the bank in excess of the policy limits. Considering the economic climate and public backlash against supposed excesses by financial institutions, such lawsuits could yield windfall jury verdicts that far exceed any coverage limits. There are significant risks in facing a jury, particularly in this culture where anger and frustration directed at banks may cloud or trump jury instructions and legal analysis.

Bank policyholders need to be aware of these arguments not only when they are forced to respond to such coverage positions, but also when they are purchasing coverage. Coverage defenses such as those described above usually are fact-specific and, although they have been accepted in certain cases where the policyholder did engage in wrongdoing, bank overdraft suits do not fit this category. Finally, many jurisdictions are silent as to whether they accept or reject the types of public policy arguments advanced by insurance companies, and decisions in various states have gone both ways. In short, policy language is important, the facts specific to each coverage denial vary and the state law that applies can be crucial. For all of these reasons, coverage denials based on the defenses discussed above should not be accepted without significant scrutiny.

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