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NEWSLETTER

Fraud Exclusion Bars Coverage for Suit Against Bank Regarding Life Insurance Premium Loans

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The United States District Court for the Central District of California has held that no coverage is available for a suit against an insured bank because of the clear language of the policy's fraud exclusion. *Nat'l Bank of Cal. v. Progressive Cas. Ins. Co.*, 2013 WL 1387196 (C.D. Cal. Apr. 3, 2013). The court additionally held that the insurer is not liable for defense costs incurred prior to the bank tendering the claim.

The bank had issued a premium loan for the purchase of a $6 million life insurance policy as part of a strategy to profit from the secondary market for life insurance policies. When the bank sought repayment of the loan from the life insurance trust, the trustees brought suit, asserting that they did not understand the documents they had signed and therefore did not know that they had signed loan documents or guaranteed repayment. The arbitrator in the underlying suit found that the loan agreement was not enforceable because of fraud in the execution or fraud in the inception regardless of whether the bank intended to defraud the trustees.

The bank's insurer denied coverage for the claim on the basis of the policy's fraud exclusion, which was modified by an endorsement to preclude coverage for "any Claim arising out of or in any way involving, in fact, any fraudulent, dishonest or criminal act or any willful violation of any civil or criminal statute, regulation or law by the Insured." The standard policy form required a final adjudication of fraud rather than the "in fact" standard found in the endorsement. The bank filed suit against the insurer, contending that the exclusion could only apply where the alleged fraud was committed with wrongful intent and that the exclusion was unclear and deceptive.

The court granted summary judgment to the insurer, finding that the fraud exclusion barred coverage for the claim. The court held that the "determinative question . . . was whether it was the mutual intention of the parties, and whether the Bank reasonably expected, to execute a fraud exclusion that would be triggered by findings such as those in the Arbitrator's Award." The court found that a layperson would interpret the words of the exclusion as encompassing as wide a range of acts as possible, noting in particular the phrase "in any way involving." The court also considered that the endorsement had removed any requirement for a final judgment or adjudication, which further increased the ways in which fraudulent acts could trigger the exclusion. Although the court applied the "layperson" standard, it observed that the bank was a sophisticated party that would reasonably expect the exclusion language to cover the different varieties of fraud under California law.

The court additionally found that the exclusion was sufficiently plain and clear, that it would attract a reader's attention and that it was not misleading. The court noted that the policy explained "endorsements," placed the fraud exclusion endorsement on its own page with a bold header, and clearly indicated that the policy language was "deleted and replaced" with the endorsement language.

The bank also sought coverage for the defense costs it had incurred as a result of several other claims. Because the bank had expended some costs in pursuing its own claims against the loan borrowers, the insurer had informed the bank that it was allocating only 20% of the costs to covered loss based on the relative legal exposure of the bank. The insurer also requested a determination from the court that it was not liable for costs incurred before the bank tendered the claims.

The court held that the bank was not entitled to recover the defense costs incurred before it gave notice of the claims to the insurer. The court looked to the policy language stating that the "Insured shall not incur Defense Costs . . . without the Insurer's prior written consent." However, the court declined to grant summary judgment on the issue of how the defense costs should be allocated–or the bank's related claim that the insurer had breached the covenant of good faith and fair dealing by allocating only 20% of the costs to covered loss–because there was insufficient evidence on the record to establish whether the insurer had correctly determined what portion of the legal expenses were not covered or that the coverage decision was reasonable.