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Bank Settles Vexatious refusal Suit For \$1.75M

Claim Was Made For Consequential Damages



Don Downing

BY AARON BROWN

A bank that suffered \$1.1 million in embezzlement losses has settled its Dunklin County vexatious refusal case against its fidelity bond insurer for \$1.75 million.

St. Paul Mercury Insurance Company initially denied the claim after a nine-month investigation, arguing that the First National Bank of Malden should have known the employee was stealing money.

But the bank's attorney, Don M. Downing of St. Louis, convinced St. Paul in settlement talks that the fraud could not have been anticipated.

According to Downing, the settlement is significant because it shows that a claim for consequential damages in a vexatious refusal case is viable.

"The insurance company argued at first that the vexatious refusal statute does not allow an insured to recover consequential damages," he said. "But we argued that the Missouri Supreme Court decision in *Overcast v. Billing Mutual Insurance Co.* suggested that consequential damages could indeed be recovered.

"I think the lesson from this case for practitioners is that you should look carefully at *Overcast* if you want to make a claim for consequential damages against an insurer."

Phony Loans

The case arose from an embezzlement scheme carried out by a bank employee in 2001 and 2002, Downing said.

The employee created 30 phony loans — some in the name of bank customers, others using fictitious names — and deposited the money in an account at another bank.

The total value of the transactions was \$1,134,000.

It was "a clear case of fraud," Downing said. The employee eventually pleaded guilty to the scheme and is currently serving a sentence in a federal prison.

First National quickly notified St. Paul of the loss, Downing said, and followed the notification with an "extraordinarily detailed proof of loss" which included extensive documentation from bank records and affidavits from customers whose names had been used for some of the fictitious loans.

St. Paul then spent nine months investigating the claim, making the bank "jump through hoops and produce every scrap of paper you can imagine" to document the matter, Downing said.

In the end, St. Paul denied the claim because it said the employee had passed bad checks in the past, which was a sufficient history of dishonesty to trigger an exclusion in the policy.

But First National argued that the employee's history pointed to carelessness, not dishonesty, and the exclusion did not apply.

"This was a guy who had overdrawn his checking accounts a few times in the past," Downing said. "But he always paid the fees and covered what he owed. Our argument was that this was sloppiness, and that it gave the bank no clue that he was dishonest."

First National hired Downing after the claim was denied.

Lawsuit

Before the lawsuit was filed, St. Paul offered \$100,000, Downing said. But the bank never dropped its demand below \$1.1 million, insisting on recovering all of what it had lost to the fraud.

"The bank's position was, why would we have bought the bond if not to cover this kind of loss?" he said. "They wanted at least to recover their direct losses from the scheme."

The filing of the lawsuit marked a decisive turn in the case. Within three weeks, Downing received a call from a St. Paul official who was clearly ready to negotiate.

The official acknowledged that the lawsuit told "a pretty compelling story," and he apologized for how the case had been handled.

He also asked Downing what it would take to settle. Downing informed him that the price had recently gone up.

"If they had acted a month earlier, the bank would have settled for \$1.1 million, the value of the fraud," he said. "But now we were getting into consequential losses that resulted from the denial of the claim."

The bank was a regulated entity required to maintain a certain amount of capital, Downing said. And the loss of more than \$1 million for a community bank was a "huge loss" that caught the attention of regulators and placed enormous pressure on the bank's operations.

"After this loss and the denial of the claim, bank officials had regulators breathing down their neck, and were forced to draw up a whole new capital plan," he said. "There were major expenditures in terms of time and energy devoted to deal with this problem."

Giving St. Paul the benefit of the doubt on the amount of time it needed to complete the investigation of the claim, Downing estimated the bank's consequential damages from the denial of the claim at \$600,000.

Under the vexatious refusal statute, it was clear that First National could recover its initial loss, plus a 10 percent penalty, and attorney's fees, Downing said.

But St. Paul raised the argument, often heard from insurers, that the Missouri vexatious refusal statute does not allow for the recovery of consequential damages, he said.

The vexatious refusal statute was "pushed through by the insurers" as an alternative to allowing punitive damages claims when coverage is denied, he said. In place of punitive damages, the statute allows the insured to recover attorney's fees and the penalty.

But the statute is silent on the issue of consequential damages arising from the denial of coverage.

"The statute doesn't say that you can get consequential damages," he said. "And the insur-

ers have always argued that the silence implies that the insured can't recover them."

But that's where the *Overcast* case came in, Downing said. Although the decision in *Overcast* did not apply directly to First National's claim against St. Paul, dicta in the decision seemed to support the recovery of consequential damages, he said.

Downing acknowledged that the St. Paul did not formally concede that consequential damages were a part of settlement, but noted that the final amount of the settlement exceeded what was explicitly provided for in the vexatious refusal statute: the amount of the claim, the 10 percent penalty, and attorney's fees.

Downing speculated that strategic considerations may have played a role in St. Paul's decision to settle.

"They may have been worried about what would happen if this case went up to the Supreme Court on the issue of consequential damages," he said. "This case may have made bad law, from their point of view."

Consequential Damages

Downing was careful to explain that the consequential damages at issue in the settlement discussions were not those incurred as a result of the employee's fraudulent conduct, but rather those from the denial of coverage.

"Of course, the bank had extensive consequential losses from the embezzlement scheme, including legal fees, the cost of investigation, employee time and so forth," he said. "But those losses were not covered by the fidelity bond. In fact, they were specifically excluded from the coverage."

But the losses from the denial of coverage were another matter altogether, he said.

"Our point was that this was similar to an ordinary breach of contract claim, in which consequential losses are allowed," he said. "We were seeking recovery of the losses that came from the breach of their contract to pay, that were a consequence of the breach."

"And we were very careful to segregate those losses from the losses that had to do with the fraud."