

Trust Officer's Risky Investment Strategy Covered by D&O Insurance

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The Seventh Circuit has affirmed a trial court's ruling in favor of the policyholder, determining that a bank employee's risky investment strategy as a trust officer was not barred by an "actions taken in bad faith" exclusion, a dishonesty exclusion, or an exclusion for claims arising from the "method of funding" of trust accounts. *Citizens First Nat'l Bank of Princeton v. Cincinnati Ins. Co.*, Nos. 98-3534, 98-3535 & 98-3957, 2000 U.S. App. LEXIS 527 (7th Cir. Jan. 14, 2000).

The trust officer of a bank elected to invest the vast majority of his customers' life savings in extremely volatile derivative instruments, including "collateralized mortgage obligations" and "inverse floaters." The trust officer characterized these risky investments as an "aggressively conservative" buying opportunity. A number of customers complained to the bank after sustaining losses. The bank terminated the trust officer's employment and spent over \$5 million in liquidating the high-risk investments and making restitution to the customers.

The bank sought indemnity for these losses under its directors and officers liability policy, but the insurer denied coverage based on three exclusions in the policy: (1) an exclusion barring coverage for claims "arising from actions taken in bad faith;" (2) an exclusion barring coverage for losses arising out of "dishonest, fraudulent, criminal, or malicious acts;" and (3) an exclusion for claims arising from the "method of funding" of trust accounts. Following a trial, the lower court found that coverage existed and awarded attorneys' fees and costs to the policyholder on the ground that the insurer acted "vexatiously and unreasonably" in denying coverage.

The Seventh Circuit affirmed in part. It rejected the insurer's argument that the bad faith and dishonesty exclusions applied by deferring to the trial court's determination that the trust officer acted with a "pure heart, but an empty head." According to the Seventh Circuit, the lower court's findings of fact did not "strike us as wrong with the force of a 5-week-old, unrefrigerated dead fish" as required by the "clear error" standard of review. The court also reasoned that the policyholder's interpretation of the bad faith exclusion as requiring some intentional wrongdoing was reasonable and construed the term against the insurer, which argued that recklessness would suffice. The court also rejected the applicability of the "method of funding" exclusion, holding that it reasonably could be read to apply only to claims arising out of the initial method of placing money into a trust.

Lastly, the court held that the insurer had not acted "vexatiously and unreasonably" in denying coverage because the policyholder had failed to provide the insurer with complete information that would enable it to determine the complete facts bearing on the coverage issues presented by the claim. Therefore, it reversed the grant of attorneys' fees and costs to the policyholder.