Swiss banking and insurance: when a PI policy should not respond

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Nobody likes losing money. In times of financial crises and rampant fraud, claims raised by customers against their banks are *à la mode* and regularly lead to a claim against an insurance carrier under the bank's PI policy.

However, such claims are often not liability claims but rather claims for fulfilment of the bank's contractual obligations. This is frequently misunderstood by the lawyers of the bank's customers with regard to the alleged 'liability', and by the lawyers of the banks with regard to the question of coverage under a PI policy. The insurer better make sure not to fall into the same trap.

Case 1 (judgement of the Swiss Federal Supreme Court of 24 April 2006):

> Based on a forged transfer form (photocopied signature) and further instructions by telephone and fax by the external asset manager of two bank customers holding a joint account, the bank transferred US$250,000 to an unrelated third party and debited the joint account. The bank customers filed a claim for damages for US$250,000 against the bank.
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> The court ruled that the bank had to pay the claimed amount. It, however, pointed out that the customers' claim was a claim for fulfilment of the bank's contractual obligations vis-à-vis the customers.
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> The bank was not entitled to debit the customers' account in the first place.

Case 2 (judgement of the Commercial Court of the canton of Zurich of 24 January 2006):

> A bank claimed around CHF 10 million under a PI policy from its insurance carrier. In a nutshell, the facts of the case were the following: an employee of the bank received an order by a customer to buy €50 million against US Dollars at an exchange rate of 1.0725. Instead, the employee *sold* €50 million against US Dollars at an exchange rate of 1.0726. While the bank, thereafter, conducted various transactions in order to recover the loss caused by this error, damages of roughly CHF 10 million remained.
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> The court ruled that the customer's claim against the bank was not a liability claim but a claim for fulfilment of the bank's contractual obligations. On the one hand, the customer could still have requested the purchase of €50 million according to the original order. On the other hand, he still had his claim against the bank for the original balance of the account before the unauthorised transaction. The court concluded that claims for fulfilment are not covered under a PI policy as a matter of principle, ie, even if they are not explicitly excluded in the policy. As a consequence, the bank's claim was dismissed.

It is thus worth taking a closer look at the nature of such claims and at Swiss mandate law which governs the relationship between bank and customer (Article 394 ff of the Swiss Code of Obligations – CO).

Article 402 paragraph 1 CO reads as follows (tentative English translation): 'The principal is obliged to reimburse the agent for costs and expenses incurred by him in the proper performance of his mandate, plus interest thereon, and to release him from any and all obligations which he has assumed.'

When a bank transfers money to a third party or executes market trades on behalf of a customer, it disposes of its own funds. Based on Article 402 paragraph 1 CO, the bank is however entitled to claim from its customer (the principal) reimbursement of the costs and expenses incurred by it in the proper fulfilment of its mandate. This is done by debiting the customer's account in the amount of the customer's order. However, if the bank executes a transaction without a respective instruction from the customer, such transaction is none of the customer's concern and the bank is not entitled to reimbursement. The customer's claim

against the bank for the original balance of the account remains unchanged. This is a claim for fulfilment of the bank's contractual obligations and not a claim for damages (ie, not a liability claim).

Frequently, banks stipulate in their general terms and conditions that the risk of a transaction based on forged instructions should be borne by the customer unless the bank acts with gross negligence ('risk shifting clause'). It is disputed if and to what extent such clauses are valid under Swiss law. To the extent that they *are* valid, they establish a liability of the customer vis-à-vis the bank (and not the other way round).

The following examples illustrate the above mentioned principles:

- Customer A instructs his bank to transfer 1,000 to B. The bank transfers 1,000 to C and debits A's account. C does not repay the money. A claims for restoration of his account balance.
  As mentioned above, the bank disposes of its own money in the first place. Because the bank's transfer to C took place without instructions from customer A, the bank is not entitled to reimbursement and is therefore not entitled to debit A's account. If it nevertheless does so, A may rightfully protest. His claim for reinstatement of the original account balance is a claim for proper fulfilment of the bank's contractual obligations and not a claim for damages. Therefore, this claim is typically not covered under a PI policy.
- The bank recommends to its client B, who has a conservative investment strategy, the purchase of shares of the company XYZ which is a start-up company. B agrees and instructs the bank to purchase these shares for the customer's account. The client sustains a total loss and claims reimbursement of his loss from the bank. He alleges that this investment was not in line with his risk profile and that the bank had failed to properly disclose the related risks. The bank acted according to proper instructions from B and was therefore entitled to debit B's account. However, the customer accuses the bank of a breach of contract (wrongful advice). B's claim is a claim for damages (a liability claim) which is typically covered under a PI policy.
- The bank transfers 100,000 from C's account to D on the basis of a forged transfer form. The amount cannot be recovered from D. Based on a risk shifting clause in the contract between the bank and the customer, the bank's position is that the damages have to be borne by the customer (C).
  If the risk shifting clause is valid, C is liable vis-à-vis the bank and has to indemnify the bank for the loss which the bank has suffered by paying out the 100,000. If the risk shifting clause is not valid, the bank was not entitled to debit C's account. C has a claim for reinstatement of the original account balance which is a claim for fulfilment of contract. In this latter case, the bank has suffered a first party loss which normally is not recoverable under a PI policy.

Nobody likes losing money. Hence, it is worthwhile for insurance carriers to carefully analyse the nature of claims for which coverage is sought.