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COMMERCIAL CRIME POLICIES: COVERAGE ISSUES RELATED TO SETTLED CLAIMS AND DIRECT THIRD-PARTY CLAIMS

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I. INTRODUCTION

Commercial Crime Policies are first-party indemnification contracts between an insurer and its insured, providing fidelity coverage to protect insured-employers against the risk of loss caused by the dishonesty of their employees. As such, Commercial Crime Policies are not intended to cover third-party losses, except third-party property lost due to employee dishonesty while in the possession of the insured employer. However, claimants have continued to pursue attempts to expand the scope of covered losses under Commercial Crime Policies, seeking coverage for claims where the only sustained "loss" being pursued is either by the insured-employer after having reimbursed such a third-party for damages caused to it by the dishonesty of the insured's employee, or by direct action by a third-party for such claimed damages.

II. COMMERCIAL CRIME COVERAGE GENERALLY

A significant body of case law interpreting various policy provisions has developed since the simplified Commercial Crime Policy Forms were first released in 1980, and then revised more than a decade ago. As a result of the implementation of the revised language in the policies, and in particular the new definition of "Employee Dishonesty", it is fair to say that the intentions of the drafters of such policy provisions have been accomplished in that the narrow scope of coverage intended has generally been met. [1] As noted in one early case, the paradigmatic scheme covered by such polices, and the new definition of "employee dishonesty", has essentially reduced covered losses to the case of outright theft or embezzlement.[2]

A review of the entire body of case law developed in the last two decades of Commercial Crime Policy coverage is beyond the scope of this paper.[3] The focus of this paper will be on an insurer's liability for third-party losses, either as claimed damages from its insured's perspective resulting from judgments or settlements paid by the insured to third parties, and attempts by third parties to assert direct liability against the insurer for such claims. As discussed below, certain key policy provisions are particularly applicable to the discussion.

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[1] For an excellent chronological summary of the "New Definition" cases interpreting the "Employee Dishonesty" definition, see Farley, What is Employee Dishonesty? "A Louisiana Perspective: 'Tell Them I Lied' ", ABA Fidelity and Surety Law Committee of the Tort and Insurance Practice Section, Commercial Crime Policy, November 1996.

[2] Verex Assurance, Inc. v. Gate City Co., 1984 WL 2918 (D.Utah, unreported, 1984).

[3] A comprehensive study discussing nearly the entirety of the extant case law in this area can be found in Franklin, Christopher J., Legal Liability for Third-Party Losses Under Commercial Crime Policies, ABA Fidelity and Surety Law Committee of the Tort and Insurance Practice Section, 1995 Midyear Meeting Program.

III. BOND PROVISIONS APPLICABLE TO THIRD-PARTY LOSS ANALYSIS

Generally, three separate forms make up the basics of most Commercial Crime Policies - (1) the Declaration Form, (2) the Employee Dishonesty Coverage Form, and (3) the Crime General Provisions Form. Set out below are key sections from each of these forms which are particularly relevant to any analysis of third-party claims, direct and indirect and which often come up in the existing case law.

Coverage, if any, will arise under Insuring Agreement "A" of the Comprehensive Crime Form, which provides:

> The Company, subject to the Crimes Declarations made part of this policy, the General Agreements, Conditions and other terms of the insuring form, agrees with the insured, in accordance with the insuring agreements hereof as are specifically designated by the insertion of an amount of insurance in the Crime Declarations, to pay the insured for:
>
> > A. Employee Dishonesty Commercial Blanket Coverage: Loss of money, securities and other property which the insured shall sustain, to an amount not exceeding in the aggregate the amount stated in the Crime Declarations applicable to this Insuring Agreement A, resulting directly from one or more fraudulent or dishonest acts committed by an employee, acting alone or in collusion with others.

(Insuring Agreement "A") (emphasis added).

Coverage is limited, or defined by the Employee Dishonesty Coverage Form, and the Crime General Provisions Form. Under the former, the insurer agrees to "pay for loss of, and loss from damage to, Covered Property resulting directly from the Covered Cause of Loss." (Employee Dishonesty Coverage Form, Section "A"). "Covered Cause of Loss" is further defined as "Employee Dishonesty". The definition of "Employee Dishonesty", at Section A.3., is as follows:

> a. "Employee Dishonesty" in paragraph A.2. means only dishonest acts committed by an "employee," whether identified or not, acting alone or in collusion with other persons, except you or a partner, with the manifest intent to:
>
> > (1) Cause you to sustain loss; and also
> >
> > (2) Obtain financial benefit (other than employee benefits earned in the normal course of employment, including: salary, commissions, fees, bonuses, promotions, awards, profit sharing or pensions) for:
> >
> > > (a) The "employee"; or
> > > (b) Any person or organization intended by the "employee" to receive that benefit.

(Employee Dishonesty Coverage Form, D.3.) (emphasis added).

Coverage is further modified by several important exclusions and conditions in the Crime General Provisions Form, including the "Indirect Loss" exclusion at A.3., and the Ownership of Property condition at B.12. The "Indirect Loss" exclusion is particularly applicable to any discussion of third-party losses. It provides that there will be no coverage under the Bond for:

> Loss that is an indirect result of any act or "occurrence" covered by this insurance including, but not limited to, loss resulting from:
>
> a. Your inability to realize income that you would have realized had there been no loss of, or loss from damage to, Covered Property.
>
> b. Payment of damages of any type for which you are legally liable. But we will pay compensatory damages arising directly from a loss covered under this insurance.
>
> c. Payment of costs, fees or other expenses you incur in establishing either the existence or the amount of loss under this insurance.

(Crime General Provisions Form, Exclusions, A.3.)

Finally, an attempt to further restrict third-party losses was made by strengthening the language regarding covered property to favor the insured. The standard Ownership of Property condition in place since the 1980 revisions provides:

> The property covered under this insurance is limited to property:
>
> a. That you own or hold; or
>
> b. For which you are legally liable.
>
> However, this insurance is for your benefit only. It provides no rights or benefits to any other person or organization.

(Crime General Provisions Form, B.12.) (emphasis added).

As discussed in more detail below, although perhaps the strongest evidence of the insurer's intent to avoid liability to (or for) third-party losses, the last two sentences of Section B.12 have been surprisingly untested in published case law.

IV. LEGAL LIABILITY FOR THIRD-PARTY CLAIMS IN GENERAL

The issue of an insurer's legal liability for third-party losses under Commercial Crime Policies generally arises in the context of an insured's claim based upon a judgment entered against it and in favor of a third-party, a settlement reached by the insured with a third-party, or in the context of direct third-party claims asserted against the insurer. Cases dealing specifically and directly with such issues under Commercial Crime Policies are few; however, a significant body of case law exists reviewing the liability of the insurer for such third-party losses under fidelity bonds in general. The efficacy of the majority of these cases is arguable due to the fact that they were decided prior to the adoption of revised policy provisions central to such decisions.

Leading treatises in the insurance law area appear to differ on an insurer's liability to its insured for damages paid by the insured to a third-party harmed by the dishonest acts of the insured's employees. In a section entitled "Loss Through Creation of Liability of Employer to Third Person", the Couch On Insurance treatise states that:

> the loss covered by an employee's fidelity bond is not necessarily limited to loss directly resulting from the employee's act, such as embezzlement. To the contrary, it may include liability on the part of the insured resulting from the application of the principals of vicarious liability. In other words, a bond insuring against loss sustained by reason of dishonesty, fraud, embezzlement, etc., covers losses imposed by the creation of liability to third persons. To illustrate, it has been held that a loss may be suffered by the insured through being required to make good an obligation to a third person created by the fraud of its employee perpetrated on such third person.

Anderson, 13 Couch on Insurance, 2d § 46:101 (1982) at 89 (Citations omitted).[4]

In contrast, Appleman's Insurance Law and Practice finds that "[n]ewer [authority holds] that the liability of the insured-employer to third parties based upon the fraudulent or dishonest act of an employee does not constitute a loss under the Employers' Fidelity Policy."[5] The view of Appleman's Insurance Law appears to coincide with the language in most modern policies and, in particular, the exclusions provided under the Section A.3 "Indirect Loss" exclusion, which specifically provides that there would be no coverage for any loss resulting from "payment of damages of any type for which [the insured is] legally liable."

Several cases have strengthened the position of insurers that there is no liability for third-party losses under modern Commercial Crime Policies. In Mortell v. Insurance Company

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[4] Couch is itself arguably internally inconsistent. A leading case in the body of case law rejecting third-party liability under fidelity bonds, Ronnau vs. Caranvan International Corp., 205 Kan. 154, 468P. 2d 118 (1970) relied on language found elsewhere in Couch, and which has been preserved in the revised edition of the treatise. That language, at § 46-219 states as follows:

> The contract of fidelity insurance is a contract against loss. It is a contract of indemnity on which the insurer is liable only in the event of loss sustained by the obligee in consequence of conduct of nature specified in the contract. It has been held that there can be no recovery on a fidelity bond in the absence of loss or damage to the insured, and lack of any pecuniary loss by the obligee from the alleged wrongful act constitutes a good defense, in such a case no recovery can be had.

[5] 9A Appleman's Insurance Law and Practice (1981 & Supp. 1994) 6, § 5666 (Citations omitted).

of North America,[6] the insured was a licensed futures commodity merchant. Due to the dishonest and deceptive practices of several of its sales personnel, the insured was found liable to an injured third-party. Interestingly, the losses at issue spread out over two different policy periods, leading to a dichotomy in the decision which is instructive as to the limiting language of the modern policies. The pre-amendment losses were found to be covered; however, the post-amendment losses were not covered. The decision clearly implies that the post-amendment decisions were barred under the "new definition" provisions of the policy, due to the fact that the fraud of the salesman at issue was directed at the customers and not the "insured" as required under the policy.

Unfortunately, not all recent cases have strengthened the position of insurers under the modern policies. In First American State Bank v. Continental Insurance Company,[7] the Court found in favor of the insured for "losses" resulting from the insured's duty to settle with customers due to its vicarious liability for the dishonest act of its employees. This decision was reached in spite of the fact that the policy at issue contained the newer definition of "Employee Dishonesty" described above and found in most modern policies.

At issue in First American was a fraudulent loan and commodity trading scheme operated by the bank's chief agricultural loan officer. Several customers of the bank borrowed money against their lines of credit and loaned the money back to the agricultural loan officer. The loan officer also improperly managed commodity accounts in a cattle feeding operation in the name of one of the customers, taking improper commissions and failing to properly share in the losses suffered in the account. The loan officer was ultimately unable to pay the notes he had executed to the two customers. Facing perceived liability to its two customers based upon the actions of its employee, the bank elected to "settle" all claims by its customers through advancement of funds to the customers in order to allow them to "pay" the notes.

Although aware that the policy contained manifest intent language which required that the wrongful conduct of its employee be directed toward the insured in order to constitute a "loss" under the policy, the Court did not discuss that issue. Instead, the Court found that the bond was a "statutory" bond due to the fact that the bank was required to have such a bond by Iowa statute, and, therefore, the bond had to be liberally construed. Under the Court's "liberal" construction of the bond language, the bank-insured was found to have sustained a loss as a result of each dispersal of loan funds under the scheme, as well as any settlement payments to third-party customers.

In Commercial Bank of Bluefield v. St. Paul Fire and Marine Insurance,[8] the insured's employee misappropriated funds, causing losses directly to the insured and to a third-party customer of the insured. The third-party sued the insured and obtained a default judgment. The Court in Bluefield found that the fidelity bond insurer was liable to its insured for the direct losses suffered by the insured, and further held that the third-party judgment creditor could garnish the insurance proceeds that the fidelity bond insurer owed its insured.[9] However, in so finding, the Bluefield court also held that the insured's legal liability to the third-party

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[6] 120 Ill.App.3d 1016, 458 N.E.2d 922 (1984).
[7] 897 F.2d 319 (8th Cir. 1990).
[8] 336 S.E.2d 552 (W.Va. 1985).
[9] Id., at 556 - 557.

customer resulting from the employee dishonesty was not a covered loss. Id. at 556.

In Omaha Bank for Cooperatives v. Aetna Casualty Insurance Surety,[10] a bank employee made fraudulent representations to a third-party customer. The customer sued the bank for damages resulting from the fraudulent representations. While the customer's case was pending, the bank sued its blanket fidelity bond insurer seeking a declaratory judgment that any judgment in favor of the customer in the underlying suit would be a "covered loss" under the fidelity bond. The court in Omaha found that any judgment paid by the bank to a third-party would not be covered. The court noted that because the insured bank was vicariously liable due to its employee's act, the bank itself had committed the tort. Therefore, the court found that the fidelity bond would not insure the bank for consequences of its own torts, even when a bank employee actually committed the tort. Although the decision in Omaha appears to provide another theory for fidelity carriers to deny liability for judgments or settlements paid by their insured to third-parties, it is not a theory which has otherwise been referenced in the reported case law.

A. Legal Liability for Settled Claims

Numerous reported cases exist wherein an insurer has been found liable for a claim by its insured resulting from a settlement paid to a third-party by the insured for damages allegedly resulting to the third-party as a result of the dishonesty of the insured's employee. The applicability of some of these decisions to a case involving policy language from the modern version of the Commercial Crime Policy is questionable, however, they must be considered in any thorough analysis. Critical to any analysis of such claims by the insurer are the following issues: (1) whether there was actually a "loss" sustained by the insured; (2) whether the underlying claim by the third-party would have led to legal liability of the insured; and (3) whether the insurer was prejudiced by a voluntary settlement entered into prior to any notice to, or involvement by, the insurer.

Several early cases dealing with the insurer's liability for claims settled by the insured found the existence of a "loss" by the insured through somewhat strained reasoning. In Hooker v. New Amsterdam Casualty Company,[11] the claim at issue involved misappropriation of county funds by the bank's President who was also treasurer of McCracken County. The county ultimately filed suit against the bank which was resolved by settlement. The bank then made a claim under its fidelity bond. The Court rejected the insurer's argument that there was no "physical property" losses by the insured, and that the only loss was of a "depositor" and therefore not covered. In rejecting this argument, the Court found that the "payment of a legal liability caused by the dishonest act of the employee is a 'loss of money' to the same practical effect as it would be if the employee actually took the money out of the till."[12] The decision in Hooker appears to be based on rather broad language in the bond obligating the insurer to indemnify the insured "and hold it harmless from and against any loss of money . . . ".[13]

Several other early cases, predating the "new definition" policies, found coverage for settlements based on the insured's "loss of bargain" or "depletion of pecuniary value". In

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[10] 301 N.W. 2d 564 (Nebraska, 1981).
[11] 33 F.Supp. 672 (W.D. KY 1940).
[12] Id., at 673.
[13] Id.

National Surety Corp. v. Rausche Pierce and Co., Inc.,[14] the insured brought a claim under a broker's fidelity bond for settlements ultimately reached with several of its customers. The settlements were the result of claims asserted by the customers for losses stemming from misrepresentations by an employee of the insured in an offering circular. The insured suffered a "loss of the bargain" on the original sale of the securities to such customers.[15] In a somewhat tortured analysis, the 5th Circuit found that the insurer's "loss of the bargain" was essentially equivalent to a judgment being obtained by a third-party. In a rather liberal interpretation of lost property, the Court found that if the insured was "worse off" as a result of the settlement, a loss of property had occurred. The fact that such a loss had resulted from the insured's liability to a third-party was not directly considered by the Court.[16]

In rejecting claims based upon an insured's settlement with a third-party, several courts have properly focused judicial inquiry on the issue of whether the insured was legally liable for the claim which led to the settlement for which recovery was sought. In KAMI Kountry Broadcasting Co. v. USF&G,[17] an employee of the insured forged signatures of the insured's president on a promissory note in favor of a local bank. Under applicable Nebraska law, the insured was clearly not liable for the acts of its dishonest employee. Notwithstanding the lack of legal liability the insured elected to pay the note in order to maintain relations with the bank which happened to also be an important customer of the insured. After paying the note, the insured filed a claim under its fidelity bond.

The KAMI Court found in favor of the insurer based on the theory that the insured had suffered no "loss" due to the fact that it could not have been found legally liable to the bank. The Court also implied that there would have been no coverage even in the event of legal liability to the bank due to the fact that the fraud of the employee was directed at the third-party and not the insured. The KAMI Court was clearly influenced by the voluntary nature of the insured's payment, and the applicability of this case to other cases where there is clear liability of the insured to a third-party is, at best, questionable.

In First American State Bank v. Continental Insurance,[18] the court found the insurer liable for a claim by its insured bank under a blanket fidelity bond where the insured's claim arose from payment of money to settle with third-parties injured by the dishonest act of the bank's president. In First American, the blanket bond at issue stated that the insurer would pay for dishonest acts of the bank's employees "whether or not the Insured is liable therefor".[19] Language such as this is much broader than the standard language now employed in the "Indirect Loss" provisions of Commercial Crime Policies and, therefore, makes this case distinguishable from cases brought under traditional, modern policies.

Several modern courts have seemingly refused to recognize the distinction between general liability policies and fidelity bonds in order to find coverage for third-party losses. In

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[14] 369 F.2d 572 (5th Cir. 1966).

[15] Id., at 578.

[16] See also Imperial Insurance, Inc. v. Employer's Liability Assurance Corp., 442 F.2d 1197 (D.C. Cir. 1970) (loss through settlement by insured was a "pecuniary depletion" of insured's assets and, in that sense, a loss of its property and therefore covered under the general expression "other property" in the policy).

[17] 190 Neb. 330, 208 N.W.2d 254 (1973).

[18] 897 F.2d 319 (8th Cir. 1990).

[19] Id., at 325.

Manley, Bennett, McDonald v. St. Paul Fire & Marine,[20] the court held the insurer liable under a stockholder's partnership bond and a stockholder's blanket bond, where the asserted claim resulted from the insured's settlements with third-parties harmed by the dishonesty of its partners and employees. Although characterized as a bond, the court found the language of the policy sounded more in "liability insurance" than in fidelity bond, stating as follows:

> the [insurer] will indemnify the Insured against court costs and reasonable attorneys fees incurred and paid by the Insured in defending any suit or legal proceeding brought against the Insured to enforce the insurance liability or alleged liability on account of any laws, claim or damages, which, if established against the insured, would constitute a valid and collectible loss sustained by the insured under the terms of this bond.[21]

The language was found to be ambiguous as to the issue of whether it covered any legal liability paid by the insured, resulting in a decision in favor of the insured.

A Florida case also presents some countervailing authority against insurers in this area. In Southside Motor Corp. v. TransAmerica Insurance,[22] the court held that a fidelity bond insurer must pay its insured's claim arising from the insured's settlement with a third-party harmed by the dishonesty of one of the insured's employee. In finding that the fidelity bond language was ambiguous as to covered losses, the court construed coverage broadly based on its feeling that the "clause at issue involves extension of coverage rather than exclusion of coverage, [and therefore] must be liberally construed in favor of the insured."[23] The court implied that while coverage provisions need to be liberally construed, coverage exclusions need not be liberally construed in the insured's favor. In a somewhat truncated opinion, the Southside Motor Corp. case makes no mention of the possible exclusion for payments made by the insured for damages for which it is "legally liable", as generally exists in the standard Commercial Crime Policy now in use.

A more recent decision rejecting liability of an insurer for settlements made by its insured is Drexel Burnham Lambert Group, Inc. v. Vigilant Insurance Company,[24] a trial court decision from the State of New York. The Drexel case arose out of the demise of the junk bond empire created by Michael Milken and others in the 1980's. After settlement with numerous third-parties as a result of the activities of its employees, Drexel asserted claims under several of its fidelity bonds to cover such settlements. Although not going into great detail as to the basis of the rejections, the trial court judge rejected all claims of Drexel, finding that the policies at issue were fidelity bonds and not general liability insurance policies and that they did "not purport to defend and indemnify the insured every time a claim is made against it because it may be responsible for the acts of its employees."[25]

Hopefully more modern courts will continue to recognize the distinction between general

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20 792 F.Supp 1070 (E.D. Mich. 1992).
21 Id.., at 1072.
22 380 So.2d 470 (Fla. App. 1980).
23 Id.., at 471.
24 157 Misc.2d 198, 595 N.Y.S.2d 99 (S.Ct. 1994).
25 Id., at 209.

liability policies and fidelity bonds in deciding cases involving insured's settlements with third-parties. The policy provisions added in the 1980 amendments to such policies should assist the courts in that regard, and lead to more decisions rejecting claims based upon settlements reached with third-parties for losses sustained by someone other than the actual insured.

B. Legal Liability for Direct Third-Party Claims

The issue of whether a third-party can itself successfully maintain an action against an insurer under a Commercial Crime Policy, although often presenting itself in the same factual context, is different from the issue of whether an insured's legal liability to such a third-party is a "covered loss" under such a policy. Any number of policy provisions in Commercial Crime Policies lead to the logical conclusion that there would be no legal liability under such policies to third-parties, and therefore, no right of direct action by such third-parties. In particular, Insuring Agreement A specifically requires that the "insured" sustain a loss, as opposed to a third-party. Moreover, the "Employee Dishonesty" definition now contained in most bonds requires that the employee act with the manifest intent "to cause the insured to sustain a loss", as opposed to the intention to cause a third-party to sustain a loss. Last but not least, the ownership language commonly found in Commercial Crime Policies (Crime General Provisions, Section 12), in addition to specifically stating that covered property is only that which is owned by the insured or for which the insured is legally liable, specifically states that "this insurance is for [the insured's] benefit only. It provides no rights or benefits to any other person or organization." Most modern courts rejecting third-party claims have taken one or more of the provisions mentioned above and found that claims by such third-parties are not covered under the bond. Surprisingly, the language in Section B.12. has been virtually ignored in such decisions.

Litigants have generally advanced one or more of several theories in support of direct third-party claims against insurers under fidelity bonds. Those theories include: (1) third-party beneficiary liability; (2) Statutory Bonds and Direct Action Statutes; (3) Garnishment; and (4) Assignment theories. Cases under each theory, to the extent they exist, will be reviewed and analyzed.

One of the earliest theories often put forward for direct action by a third-party under a fidelity bond is the theory of "third-party beneficiary" liability of the insurer. Most courts which have even entertained the "third-party beneficiary" theory for purposes of evaluating potential liability for third-party losses have refused to imply a direct right of action in favor of such a third-party in connection with a fidelity bond. The primary reason given for such refusals is the belief that to do so would in effect judicially transform a first party indemnity contract of insurance into a general liability policy.

In a case pre-dating the "new definition" provision, Thomas Cumis Insurance Society, Inc. v. Republic National Bank of Dallas,[26] the third-party beneficiary theory was again successful. Cumis insured two credit unions under identical bonds. Republic National Bank, a third-party not party to either bond, delivered blank travelers check to each of the credit unions which were subsequently stolen, filled in and negotiated. Republic paid the travelers

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[26] 480 S.W.2d 762 (Tex.Civ.App. 1972).

checks and then sued Cumis directly on its bonds issued to the credit unions based upon the theory that it was a third-party beneficiary of the Cumis bond.

The theory of recovery centered on the bond's definition of "property" which identified specific items in which the credit union insured's had a "pecuniary interest or which are held by the Insured in any capacity, and whether or not the Insured is liable therefor."[27] The Court found that the credit unions held the travelers checks as bailees, therefore, the bank did not have to first establish the credit unions liability before Cumis would be liable to someone. Notwithstanding the Cumis decision, a majority of the Courts have found that fidelity bonds are not contracts for the benefit of third-parties and have rejected any "third-party beneficiary" theories.

In American Empire Insurance Company of South Dakota vs. Fidelity and Deposit Company of Maryland,[28] the insured was a clearing house for insurance companies responsible for collection of premiums and payment of claims. A number of irregularities were discovered by pool participants, who, in turn, brought an action against the insured's fidelity bond carrier claiming they were third-party beneficiaries on the bond.

In rejecting the third-party's claims, the court in American Empire correctly interpreted the fidelity insurance contract as being designed solely to reimburse the named insured for losses sustained by it and found that "[a] distinction must be drawn between indemnity and property insurance. The fidelity bond was an indemnity insurance contract. The insurer's liability does not arise until the insured has suffered a proven loss. . . . We are of the firm view that [the insurer's contract] meant just exactly what it clearly said, that is, that it insured the named corporations and those corporations only, against the defalcations of their employees."[29] The court's decision to refuse to extend Florida's liberal rule permitting third-party beneficiaries to sue directly on liability insurance contracts to fidelity bonds was aided by the facts of the case itself. In reviewing the evidence before it, the court paid particular attention to correspondence between the insured and the insurer indicating the pool participants' interest in having coverage extended to provide them with direct protection, and, more importantly, the fidelity insurer's express refusal to extend that coverage. The pool participants also focused their arguments on the "ownership clause" in the policy which provided for coverage to "property as respects which the insured is legally liable", which they argued operated to protect third-parties and should therefore enable such third-parties to bring action under the bond. The court rejected this argument as well, finding that losses of property suffered by its insured were covered, whether the insured was liable for such losses or not.[30]

The Fifth Circuit again rejected the "third-party beneficiary" theory in a subsequent case entitled Everhart vs. Drake Management, Inc.[31] In Everhart, the insured was in the business of providing funding service for construction and general mortgage loans. The third-party bank was injured when funds forwarded by it to the insured for a specific construction project were used by the insured to cover other debts. A third-party bank then filed a direct claim against

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27 Id., at 763.
28 408 F.2d 72 (5th Circuit 1969).

29 408 F.2d at 77.
30 408 F.2d at 76.
31 627 F.2d 686 (5th Cir. 1980).

the insured's fidelity bond.

In rejecting the third-party claim, the Fifth Circuit again distinguished fidelity bonds from general liability insurance contracts, finding that a "blanket fidelity bond issued by Insurer protects against losses sustained by [the insured] due to fraudulent acts or omissions of its own employees . . . fidelity insurance undertakes to protect the insured against loss incurred by the insured or any predetermined specified group . . . cases extending coverage under a liability policy [are] not applicable to fidelity bond contracts where the parties, whose losses are insured, are readily defined, specified and predictable."[32] The court also found that the insured had sustained no "loss" covered under the bond at issue. Equally important in the area of rejecting third-party claims under fidelity bonds, the court noted that the "legal liability of the insurer to the [third-party] bank cannot be predicated on one owed by [the insured] to the bank."[33]

A more recent case arising in Florida adopted the analysis of both American Empire as well as Everhart. In Gasslein vs. National Union Fire Insurance Company of Pittsburgh,[34] the Plaintiff, Patricia Gasslein, was injured through the fraudulent activity of a broker employed by American Pacific Securities Corporation. American Pacific was insured by National Union Fire Insurance Company of Pittsburgh under a fidelity insurance policy.

Gasslein first sought and obtained an arbitration panel award against American Pacific for $338,342.94 plus attorneys fees. Unfortunately for Gasslein, American Pacific had filed bankruptcy and the arbitration award therefore could not be enforced. Subsequent to obtaining the award, in order to obtain a judgment confirming the arbitration award, Gasslein entered into a stipulation with American Pacific's bankruptcy counsel whereby she agreed not to seek any relief against American Pacific in order that she could "pursue any and all rights . . . she has . . . against [American Pacific's] securities dealer blanket bond issued by [National Union], but only to the extent that there are insurance proceeds for any alleged liability of [American Pacific]."[35]

The bond at issue provided specifically that it was for the use and benefit only of the insured, and that National Union would not be liable "for loss sustained by anyone other than the Insured unless the Insured, in its sole discretion and at its option, shall include such loss in the Insured's proof of loss."[36] Gasslein brought an action against National Union, suing as a third-party beneficiary under the fidelity insurance policy, asserting a right to proceed against National Union in the place of American Pacific. National Union raised several defenses to the claim of Gasslein including (1) the fact that Gasslein was nether a party to the agreement nor a named beneficiary, (2) American Pacific did not suffer any "loss" due to the fact that it did not have to pay any money to Gasslein, and (3) the fact that Gasslein's loss was not discovered during the period of time in which American Pacific's policy with National Union was in effect.

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32 Id., at 691-92.
33 Id., at 690.
34 918 F.Supp. 373 (M.D. Fla. 1995).

35 Id., at 374.
36 Id., at 375.

Based on the fact that the National Union policy was a "fidelity bond", the court found the decisions in American Empire and Everhart controlling. In so ruling, the court rejected Gasslein's argument that because security dealers are required by law to maintain fidelity bonds, the case should be decided under standards applied to "statutory bonds", generally finding in favor of insurance. The court rejected Gasslein's one case in support of that theory finding that it dealt with a statutorily required liability insurance policy rather than a statutorily required fidelity bond.[37] Unfortunately, the court's decision to reject Gasslein's final theory on the ground that their legal authority applied only to statutorily required liability insurance policies leaves open the possibility that the court could find in favor of direct action by a third-party in the case of a statutorily required fidelity bond.

In straining to find coverage where seemingly none would otherwise exist, Court's have often resorted to finding that a particular fidelity bond is "statutory" in nature, and therefore entitled to liberal interpretation in favor of coverage. A relatively recent case finding in favor of a third-party demonstrates just how far Court's have been willing to go. In Anchor Equities Limited v. Pacific Coast American,[38] the Supreme Court of New Mexico found coverage in favor of a third-party under a fidelity policy where no coverage appeared to exist based upon the theory that the bond at issue was "statutory" in nature.

In Anchor Equities, the third-party at issue transferred money to the insured escrow company to finance the purchase of certain real property. Unfortunately for the third-party, the escrow agent misappropriated the funds. Without asserting a claim or filing suit against the escrow agent itself, the third-party filed a direct action against the fidelity bond carrier.

The Court found that a direct action by the third-party was proper, applying a three part test typically limited to general liability policy cases. Under the test, the Court found third-party action to be proper due to the fact that (a) the insurance was procured as a result of statutory requirement, (b) the public was an intended beneficiary of the required insurance, and (c) there was no language in the enabling statute prohibiting direct action by third-parties.

Another "direct action" case relying on the "statutory" nature of bonds which held in favor of the insurer is Hatch v. Reliance Insurance Company.[39] In Hatch, the third-party plaintiff was an investor in the insured, and asserted a claim based on alleged fraud by employees of the insured. Hatch sought and obtained a default judgment against the insured which, subsequently, was placed into receivership. Thereafter a receiver appointed for the insured filed a claim seeking to recover losses due to the fraud of the insured's various employees. Hatch filed a garnishment action against the insurer claiming priority on the bond proceeds based on his prior judgment. Somewhat involved litigation ensued requiring numerous re-hearings and re-filing of suit. All of which ultimately led to the third-party Hatch's right to sue being terminated.

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[37] Id., at 376, rejecting Pickett vs. Carolina Casualty Insurance Company, 734 F.2d 792 (11th Circuit 1984).

[38] 737 P.2d 532 (1987).

[39] 758 F.2d 409 (9th Cir. 1985).

In Foster v. National Union Fire Insurance Company,[40] the 8th Circuit found in favor of a third-party asserting a direct claim under a brokerage firm's fidelity bond under the "statutory bond" analysis. In Foster, the Court found that Arkansas public policy and law dictated that fidelity coverage be provided to third-parties and thus direct action was appropriate. Notwithstanding the fact that the plain and unambiguous language of the bond precluded such action by third-parties, the Court found that the "language of the bond, however clear, cannot control where it is contrary to the law."[41]

In contrast to Foster and the other "statutory bond" decisions cited above, at least one court has disallowed the theory in favor of insurers. In School Employees Credit Union v. National Union Fire Insurance Company,[42] a Kansas District Court rejected a direct action filed by a third-party under the school's fidelity bond noting that fidelity bonds indemnify the insured only, not third-parties, from losses. The third-party claimant was a credit union claiming to have been defrauded by a securities dealer in connection with the purchase and sale of certain securities. A direct action was filed by the credit union against the fidelity bond carrier for the securities dealer. The Court noted that securities dealers were required to provide a "surety bond" to protect third-parties, unless certain professional requirements were met. Under such circumstances, a fidelity bond could be substituted, so it would afford the necessary protection. Securities dealers who met the pre-conditions to the requirement of having a surety bond were automatically recipients of insurance coverage provided through various professional organizations. Accordingly, the court reasoned the fidelity bond requirement was not designed to protect the public and the Foster Court's "public policy" analysis and "statutory bond" analysis were rejected.[43]

An often used theory of recovery for direct third-party claims is "garnishment". In fact, one of the earliest cases discussing, and rejecting an insurer's liability for third-party losses involved garnishment. In Ronnau v. Caranvan International Corp.,[44] the Court reviewed a claim involving losses sustained by a third-party due to the fraudulent representations of an employee of the insured. The third-party had filed a lawsuit against the insured and obtained a default judgment. The third-party claimant then obtained an order of garnishment against the insurer which had denied liability under the original bond. The third-party claimant argued that the fidelity bond was, at least in part, a general liability policy based upon the language in the policy which provided coverage for losses of property for which the insured was "legally liable".[45] The Court in Ronnau rejected the argument finding that third-party losses were not covered under the policy, relying on the language from Couch on Insurance, discussed above.

Numerous cases have since adopted the Ronnau decision in support of rejecting similar claims. In Foxley Cattle Co. v. Bank of Meade,[46] a claim was asserted by a third-party who

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[40] 902 F.2d 1316 (8th Cir. 1980).
[41] 902 F.2d at 1319.
[42] 839 F.Supp 1477 (D. Kan. 1993).

[43] Another theory of recovery by third -parties under fidelity bonds are so-called "direct action" statutes existent in many states. In most cases, such statutes were promulgated for purposes of covering direct action under general liability insurance policies and not fidelity bonds. The latter, being policies of indemnity, have been found by a number of states not to be covered by such statute. See, e.g., Three Garden Village vs. United States Fidelity and Guarantee, 318 Md. 98, 567 A.2d 85 (1989) (Maryland); 175 East 74th Corporation vs. Hartford, 51 NY 2d. 585, 416 NE 2d. 584, 435 N.Y.S. 2d. 584 (NY App. (1980)) (New York); Anderson vs. Employers Insurance, 826 F.2d. 777 (8th Circuit 1987) (Iowa); and LaCour vs. Merchants Trust and Savings Banks, 153 So.2d. 599 (LA. APP. 1963) (Louisiana).
[44] 205 Kan. 154, 468 P.2d 118 (1970).
[45] Id., at 121.
[46] 196 Neb. 587, 244 N.W.2d 205 (1976).

had been injured by the false representations of the President of the Bank of Meade regarding the ownership and location of certain cattle. After obtaining a jury verdict against the Bank of Meade, and thus firmly establishing legal liability of the insured, the third-party filed a garnishment action against the insurer. The Supreme Court of Nebraska, quoting extensively from Ronnau, rejected the garnishment action.[47]

A more recent case from the State of Michigan also rejected the "garnishment" theory. In Bralko Holdings Limited v. Insurance Company of North America,[48] the third-party had previously obtained a consent judgment against the insured for illegal commissions paid in connection with the sale of certain partnership interests by the insured. The third-party then filed a garnishment action against the broker's fidelity bond, arguing that the policy language which provided that the insurer would "indemnify and hold harmless" the insured from any losses due to fraudulent and dishonest acts by its employees gave rise to coverage for third-party losses. Relying on the Ronnau decision, the Michigan Court of Appeals rejected this argument.

The Court also flatly rejected the third-parties' claims that the bond's "hold harmless" language somehow transformed a fidelity bond into a general liability policy. However, the Court made a troubling statement in its opinion to the effect that "at most" the bond would insure against a loss sustained only when a judgment was actually paid.[49] Standing alone, the Court's statement could be argued to stand for the proposition that recovery for third-party losses was possible once a judgment had been paid. The Court, however, specifically rejects any such interpretation in a related footnote.[50] In sum, the Bralko decision appears to stand for the proposition that third-party losses resulting from an insured's liability to others are not covered based upon the narrow interpretation of the bond coverage provisions, as well as ownership language deemed to cover property in the insured's custody and possession regardless of the insured's liability therefor.

Assignment is a method sometimes used by strangers to a fidelity bond in an attempt to obtain recovery where it would otherwise be disallowed. Anti-assignment provisions in fidelity bonds, including modern Commercial Crime Policies, are generally upheld. However, in the event no such provision is included in a bond, assignment may prove to be a successful theory of recovery for a third-party claimant in a direct action against the insurer.

An older case supporting direct action by a third-party based upon an assignment is Fidelity and Deposit Company of Maryland v. Reid.[51] In Reid, stock was purchased by a customer of the insured but never delivered to her. In fact, the stock was stolen by one of the insured's employees. The customer sued the insurer on the grounds that its bond obligated the insurer to hold the insured harmless against direct loss. The customer initially prevailed at the first trial; however; the insurer successfully appealed based on the theory that "as a general rule the only party entitled to sue on [a fidelity bond] is the indemnitee or some one

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47 Interestingly, the Bank of Meade ultimately paid the judgment owed to the third-party and, thereafter, filed its own claim under the subject bond. The Court rejected the insured's claim that the prior actions filed by the third-party had dealt only with the right to garnishment as opposed to the Bank's right to assert a claim under the bond, and dismissed its case based upon the doctrine of *res judicata*.

48 193 Mich. at 157, 483 N.W.2d 929 (1992).

49 Id., at 161.

50 Id. at 161, Note 3.

51 150 S.W.2d 836 (Texas Civ. App. 1941).

[sic] in his right, such as his assignee."[52]

Although the insured had subsequently filed bankruptcy, following appeal of the first trial, the third-party sought and obtained an assignment of the insured's right of action under its bond from the bankruptcy trustee. Thereafter, the third-party amended her pleadings and restated a claim against the insurer based upon her assignment rights. The third-party ultimately prevailed based upon the theory of "assignment" as described by the appellate court in its earlier decision, with the trial court also finding that the insured had sustained a recoverable "loss" due to the fact that it was unable to deliver the stock to the customer as required by contract.

V. CONCLUSION

While the debate over the effect of the "new" policy language in Commercial Crime Policies may be curbed due to the apparent tendency of courts to limit claims to the intended instances of theft or embezzlement, the courts have not yet settled on a consistent view of an insurer's liability for third-party losses, whether asserted by the insured as a result of judgment or settlement with a third-party, or asserted directly by a third-party. In the end, the limiting nature of the "new" policy language should have its intended effect in this area as well. In light of the courts' inconsistencies, however, the insurer must remain ever vigilant in connection with such claims to avoid an unintended expansion of potential claimants under Commercial Crime Policies.

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[52] Id., at 837.

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