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WHAT IS "DIRECT LOSS" AND RELATED ISSUES UNDER FINANCIAL INSTITUTION BOND AND FIDELITY BOND COVERAGES

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I. INTRODUCTION

The Financial Institution Bond (FIB), Standard Form No. 24, was derived from a series of bonds known as bankers blanket bonds that were intended to protect the insured from a number of risks typically associated with the banking business.[1] Such bonds are an agreement between an underwriter and an insured financial institution in which the underwriter agrees to indemnify the insured from loss resulting from "specific perils."[2] These perils are described in "Insuring Agreements," commonly known by the alphabetical letter designating them in the bond.[3] Insuring Agreement (A), which is the topic at hand, relates to fidelity and protects the insured from loss caused by the dishonesty of an employee, typically embezzlement. This paper will discuss Insuring Agreement (A), covering some issues more generally, while focusing particularly on what constitutes a direct loss by analyzing the relevant case law with an eye to the factual context of the fidelity case study being presented at this conference. Throughout this paper it is important to note the date of any case law interpreting the Standard Form No. 24, Financial Institution Bond, because of the revisions that have been periodically made to it.[4]

II. ELEMENTS OF INSURING AGREEMENT (A)

Insuring Agreement (A) of Standard Form No. 24 protects the insured from losses caused by the dishonesty of an employee.[5] Specifically, it provides that the underwriter will indemnify the insured for:

> (A) Loss resulting directly from dishonest or fraudulent acts committed by an Employee acting alone or in collusion with others.
>
> Such dishonest or fraudulent acts must be committed by the Employee with the manifest intent:
>
> (a) to cause the Insured to sustain such loss; and
> (b) to obtain financial benefit for the Employee or another person or entity.
>
> However, if some or all of the Insured's loss results directly or indirectly from Loans, that portion of the loss is not covered unless the Employee was in collusion with one or more parties to the transactions and has received, in connection therewith, a financial benefit with a value of at least $2,500.

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[1] Peter I. Broeman, *An Overview of the Financial Institution Bond, Standard Form No 24*, 110 BLJ 439, 442 (1993); Mary Kay Vyskocil, *Insurance Issues with Respect to Lender Liability Claims*, 385 PLI/LIT 335, 339 (1990).
[2] Peter I. Broeman, *supra* note 1, at 440.
[3] Peter I. Broeman, *supra* note 1, at 440; Mary Kay Vyskocil, *supra* note 1, at 339.
[4] Peter I. Broeman, *supra* note 1, at 443.
[5] Mary Kay Vyskocil, *supra* note 1, at 339.

As used throughout this Insuring Agreement, financial benefit does not include any employee benefits earned in the normal course of employment, including: salaries, commissions, fees, bonuses, promotions, awards, profit sharing or pensions. [6]

Therefore, there are three basic elements to claims of employee dishonesty and theft: 1) a loss resulting directly from; 2) fraudulent or dishonest acts; 3) by an employee.[7] There has been much litigation on each of these elements and a comprehensive study of all of them would be impractical. The following discussion is limited and will go into depth only on the issues of manifest intent, financial benefit, and direct loss, those being the primary issues raised by the fact scenario presented in the fidelity case study. The rest of the elements contained in Insuring Agreement (A) will receive only brief treatment. We begin with a look at the requirement of employee status.

A. EMPLOYEE

The scope of the term "employee" under the bond depends heavily on the precise wording of the fidelity bond definition and the appropriate jurisdiction's interpretation of the defining language.[8] Usually, "employee" is defined in the Financial Institution Bond under Conditions and Limitations, Definitions, Section 1(g).[9] Unfortunately, even seemingly straightforward definitions have created a surprising amount of litigation.[10]

Although it is not always obvious who counts as an employee,[11] there is a presumption of the status of employee.[12] The fundamental prerequisite for coverage under a fidelity bond as an employee is the existence of an employer-employee relationship,[13] with control being the key characteristic of that relationship.[14] Two of the most interesting employment scenarios that look heavily into the level of control are those regarding principals and high-level officers.

The focus of many fact-specific cases is whether a high-level person within the insured's business is an employee under the bond.[15] Many cases have held on a factual issue that an individual is not an "employee" *per se* just because no one had the right to control and direct such individual.[16] Some courts on the other hand, have found coverage in situations where the high-level worker essentially controlled the corporate policyholder.[17]

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[6] Peter I. Broeman, *supra* note 1, at 444-5.
[7] Robert M. Horkovich et al., *Insurance Coverage for Employee Theft Losses: A Policyholder Primer on Commonly Litigated Issues*, 19 U. MEM. L. REV. 363, 372 (1999).
[8] Robert M. Horkovich et al., *supra* note 7, at 380; John P. Connelly, Esq. et al., *Fidelity and Surety Bonds*, 385 PLI/LIT 335, 394 (2000).
[9] John P. Connelly, Esq. et al., *supra* note 8, at 394.
[10] Robert M. Horkovich et al., *supra* note 7, at 381.
[11] Robert M. Horkovich, et al., *supra* note 7, at 380.
[12] 10 Am.Jur. 2d *Banks and Financial Institutions* § 346 (citing Union Planters Corp. v. Harwell, 578 S.W.2d 87 (Tenn. App.)).
[13] *Banks and Financial Institutions* § 346, *supra* note 12.
[14] John P. Connelly, Esq. et al., *supra* note 8, at 394 (citing *see* Third Fed. Sav. & Loan Assoc. v. Fireman's Fund Ins., 548 F.2d 166, 171 (6th Cir. 1977); Kentucky Farm Bureau Mut. Ins. Co. v. Snell, 319 S.W.2d 462, 465 (Ky. 1958); United States Fidelity & Guar. Co. v. Three Garden Village Ltd., 551 A.2d 881, 882 (Md.App. 1989)).
[15] Robert M. Horkovich et al., *supra* note 7, at 383.
[16] Robert M. Horkovich et al., *supra* note 7, at 383 citing *see, e.g.,* Bird v. Centennial Insurance Company, 11 F.3d 228, 2331 (1st Cir. 1993); Tow v. Wohl (In re World Hospitality, Ltd.), 983 F.2d 650 (5th Cir. 1993); California Union Ins. Co., 948 F.2d at 566; Greenberg, 405 F.2d at 332-33; Kerr v. Aetna Casualty and Surety Company, 350 F.2d 146, 165-55 (4th Cir. 1965); McKee v. Great American Insurance Company, 316 F.2d 473, 474 (5th Cir.

In situations where there is a principal who otherwise qualifies as an employee, the equitable defense of "alter ego" may sometimes be raised.[18] Such contentions are based on the theory that the actor was really the principal who owned and controlled the inanimate insured entity, usually a corporation.[19] This doctrine states that if a wrongdoer is the equivalent, or alter ego, of the corporate policyholder, public policy and equity favor the nonpayment of an otherwise acceptable claim rather than allowing a wrongdoer to profit from his actions.[20] In most situations, however, courts find the existence of an employee/employer relationship.

B. DISHONESTY

What qualifies as a dishonest or fraudulent act can be a critical issue in fidelity bond cases.[21] The Financial Institution Bond, Standard Form 24, does not define what constitutes "dishonest" or "fraudulent" acts.[22] However, there are many different court definitions of dishonesty[23] and, therefore, it is appropriate to turn to the language used by the courts in the appropriate jurisdiction. Although courts have consistently interpreted "dishonesty" broadly with respect to fidelity bond claims, more than mere negligence, incompetence, mistake, or carelessness is required.[24] Generally, a criminal act is not necessary.[25] Bonds of this type "are designed to provide coverage for a specific type of loss characterized by embezzlement, which involves the direct theft of money."[26]

1963); Payroll Express Corp., 216 B.R. at 360-62; Prime Commercial Corp., 187 B.R. at 797; Employer's Administration Service v. Hartford Accident & Indemnity Company, 709 P.2d 559, 563-64; Home Indemnity Company v. Reynolds & Company, 187 N.E. 2d 274 (IllApp.Ct. 1962); Three Garden Village Ltd. Partnership v. United States Fidelity & Guaranty Company, 567 A.2d 85, 90-92 (Md. 1989); Drexel Burnham Lambert Group, Inc. v. Vigilant Insurance Company, 595 N.Y.S.2d 999 (Sup.Ct. 1993); *But see* Golden Door Jewelry Creations, Inc. v. Lloyd's Underwriters Non-Marine Ass'n, 117 F.3d 1328 (11th Cir. 1997) (rejecting an insurer's contention that a president who "was the corporation" because he owned the business was also an employee for the purposes of a jewelers block policy).

[17] Robert M. Horkovich et al., *supra* note 7, at 384.

[18] Robert M. Horkovich et al., *supra* note 7, at 385.

[19] Orleans Parish School Board vs. Chubb Custom Insurance Co, 162 F.Supp.2d 506 (E.D. La. 2001).

[20] Robert M. Horkovich et al., *supra* note 7, at 385 (citing *see, e.g.,*FDIC v. Lott, 460 F.2d 82, 88 (5th Cir. 1972) (finding that one in sole control of a business should not be allowed to insure himself and profit from his own fraud); Employers Reinsurance Corp. v. Landmark, 547 N.W.2d 527, 536 (N.D. 1996) (stating that the purpose of the alter ego doctrine is to prevent the wrongdoer from profiting from his own wrongdoing); Riggs v. Palmer, 22 N.E.188, 190 (N.Y. 1889) ("No one shall be permitted to profit by his own fraud, or to take advantage of his own wrong, or to found any claim upon his own iniquity, or to acquire property by his own crime.").

[21] The 8th Circuit cited the late Chief Justice Cardozo in stating that "to be 'dishonest' within the meaning of a fidelity suretyship bond *** there must exist an element of moral turpitude or want of integrity. *** 'Dishonesty unlike embezzlement or larceny, is not a term of art. Even so, the measure of its meaning is not a standard of perfection, but an infirmity of purpose so opprobrious or furtive as to be fairly characterized as dishonest in the common speech of men.'" Ritchie Grocer Co. v. Aetna Casualty & Surety Company, 426 F.2d 499, 503 (8th Cir. 1970).

[22] John P. Connelly et al*., supra* note 8, at 394.

[23] See Robert M. Horkovich et al., *supra* note 7, at 379.

[24] Robert M. Horkovich et al., *supra* note 7, at 379; *see* Midland Bank & Trust Co. v. Fidelity & Deposit Co., 442 F. Supp. 960, 977 (D.N.J. 1977); Exeter Banking Co. v. New Hampshire Insurance Co., 121 N.H. 1083, 438 A.2d 310 (1981).

[25] John P. Connelly et al., *supra* note 8, at 394.

[26] General Analytics Corporation v. CNA Insurance Companies, 86 F.3d 51, 54 (4th Cir. 1996) (citing Michael Keeley, *Employee Dishonesty Claims: Discerning the Employee's Manifest Intent*, 30 TORT & INS. L.J. 915, 919 (1995)).

Generally, courts do not find coverage under Insuring Clause (A) for losses that are "occasioned by acts or omissions not denoting conscious wrongdoing or involving moral turpitude."[27] In FDIC v. St. Paul Fire and Marine Insurance Co., the 6th Circuit discussed the most important cases addressing the definition of dishonesty in Insuring Agreement (A).[28] The 6th Circuit concluded:

> "In sum, this clause covers fraud, not bad business judgment, whether that be characterized as 'reckless and imprudent,' or just plain 'poor'. The distinction that underlies *** is the distinction between fraud and overreaching. As one court explained, after perusing the language of the provision, "[t]he paradigmatic scheme that would be covered by [Insuring Agreement A] is an embezzlement."[29]

C. MANIFEST INTENT

Standard Form No. 24 has been amended to require a manifest intent in connection with the fraudulent or dishonest acts.[30] The Financial Institution Bond requires the insured bank to prove two intents on the part of the employee: 1) an intent to cause the bank a loss, and 2) an intent to benefit the employee or some third party.[31] Both of these intents must be "manifest".[32] Manifest intent is "clearly evident intent" and may be inferred from all the circumstances and facts denoting the employee's state of mind.[33]

A minority of courts continue to struggle with the manifest intent requirement. These courts have ignored the "manifest" portion of the intent requirement by adopting a tort concept of intent.[34] Under such a concept, the actor is "deemed to have intended the natural consequences of his or her acts."[35]

The majority of courts hold that the "manifest intent" requirement is an objective standard requiring the insured to prove the employee acted with the specific objective or desire to cause a loss.[36] Such a standard focuses on not whether the employee was reckless or substantially certain a result may occur, but rather, whether the employee knew that the loss was an inevitable consequence.[37]

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[27] First National Bank v. United States Fidelity & Guaranty Co., 275 Md. 400, 340 A.2d 275 (1975).
[28] 942 F.2d 1032, 1035 (6th Cir. 1991).
[29] *Id.* at 1036.
[30] The Surety Association and the American Bankers Association are currently considering changing the "manifest intent" language contained in Insuring Agreement (A) to "conscious and purposeful intent."
[31] John P. Connelly, Esq. et al., *supra* note 8, at 394 (citing *see, e.g.,* Mortell v. Ins. Co. of N. Am., 458 N.E.2d 922 (Ill.App. 1983)).
[32] First Bank of Marietta v. Hartford Underwriters Mut. Ins. Co., 997 F.Supp. 934 (S.D. Ohio 1998); First Federal Savings and Loan Association v. Transamerica Insurance Company, 835 F.2d 1164, 1166-67 n. 3 (10th Cir. 1991)).
[33] BancInsure Inc. v. BNC National Bank N.A., 263 F.3d 766 (8th Cir. 2001); National Bank v. St. Paul Fire and Marine Insurance Co., 2 F.3d 801 (8th Cir. 1993).
[34] John P. Connelly, Esq. et al., *supra* note 8, at 394.
[35] John P. Connelly, Esq. et al., *supra* note 8, at 394 (citing *see, e.g.,* Aetna Cas. & Sur. Co. v. Freyer, 411 N.E.2d 1157 (Ill.App. 1980)).
[36] *See, e.g.,* Shoemaker v. Lumbermens Mutual Casualty Co., 176 F.Supp2d 449 (W.D. Pa. 2001); Resolution Trust Corp. v. Fidelity and Deposit Co. of Maryland, 205 F.3d 766 (8th Cir. 1993)).
[37] Ronald A. May et al., *Annual Survey of Fidelity and Surety Law*, 2001-Part II, 69 DEF. COUNS. J. 338, 344 (2002).

The addition of the "manifest intent" requirement, a stricter standard for judging dishonesty has been imposed.[38] For instance, in Federal Deposit Insurance Corp. v. National Union Fire Insurance Co., the court refused to infer manifestation of intent to cause a loss absent specific purpose to confer a benefit on third parties by causing a loss.[39] The court found the mere failure to disclose certain facts to a loan committee does not amount to manifest intent to cause a loss. Accordingly, incompetent or negligent work alone on the part of the employee is not illustrative of evil purpose.[40] Therefore, absent evidence an employee had a specific belief and purpose that the loss would result to his employer, an employee's recklessness or even knowledge that a result is substantially certain is insufficient to satisfy the manifest intent requirement.[41] This case illustrates the significance of the manifest intent requirement with regard to the dishonesty element of a claim.

For example, Illinois interprets manifest intent to require that "the actor desires to cause the consequences of his action or believes that the consequences are substantially certain to result from it."[42] In Oxford Bank and Trust, the court ruled that manifest intent exists when the circumstances indicate that a particular result is "substantially certain" or is "apparent or obvious" as a result of the employee's actions. In another Illinois case, Mortell v. Insurance Co. of North America, the court gave effect to the written terms of an unambiguous "manifest intent" rider, holding reckless disregard of the interests of the insured will not by itself indicate manifest intent to cause a loss.[43]

In New York, courts tend to look at whether or not the employee intended to harm his employer. In Glusband v. Fittin Cunningham & Lauzon, Inc., an employee, as defined by the bond, misrepresented investments to customers and began a pattern of high-risk investments.[44] The court found the requisite manifest intent was not present.[45] No matter how reckless and imprudent his conduct may have been, the evidence indicated that the employee intended to benefit the employer. Further, there was no evidence the employee ever misappropriated any of the funds for his own benefit or even received any non-exempted benefit. In the case of Leucadia, Inc. v. Reliance Insurance Co., the Second Circuit held where the employee hoped to benefit his employer and received no personal gain from the transaction, the requisite manifest intent had not been shown.[46] In New Jersey, a court held there cannot be intent to provide improper benefit to a third party who is the intended recipient and proper beneficiary of the funds.[47]

In BancInsure, Inc. v. BNC National Bank, N.A., the Eighth Circuit engaged in an analysis of what constitutes manifest intent. In this case, BancInsure issued BNC a financial institution bond.[48] A BNC employee approved numerous loans and lines of credit to a customer that were insufficiently secured and not repaid. Although the district court found

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[38] *See* Mortell v. Insurance Co. of North America, 120 Ill. App. 3d 1016, 458 N.E.2d 922 (1st Dist. 1983).
[39] Ronald A. May et al., *supra* note 37, at 343 (citing 146 F.Supp.2d 541 (D. N.J. 2001)).
[40] Ronald A. May et al., *supra* note 37, at 344 (citing 146 F.Supp.2d 541 (D. N.J. 2001)).
[41] Ronald A. May et al., *supra* note 37, at 344 (citing 146 F.Supp.2d 541 (D. N.J. 2001)).
[42] Oxford Bank and Trust v. Hartford Accident & Indem. Co., 698 N.E.2d 204 (Ill.App.Ct. 1998) (quoting Aetna Casualty and Surety Company v. Freyer, 411 N.E.2d 1157 (Ill. 1980)).
[43] 458 N.E.2d 922, 929 (Ill. App. Ct. 1983).
[44] Glusband v. Fittin Cunningham & Lauzon, Inc., 892 F.2d 208, 210 (2d Cir. 1989).
[45] 892 F.2d 208, 210 (2d Cir. 1989).
[46] 864 F.2d 964, 972-74 (2d Cir. 1988).
[47] Ronald A. May et al., *supra* note 37, at 344 (citing 146 F.Supp.2d 541 (D. N.J. 2001)).
[48] 263 F.3d 766 (8th Cir. 2001).

many "bad banking practices" by the BNC employee, it found that only two loan transactions reflected a "manifest intent" on the employee's part to cause harm to BNC. In those two transactions, the funds were used to benefit a company owned by the BNC employee. The court found that the qualifiers to covered losses, i.e. acts done with the manifest intent (a) to cause the insured to sustain the loss(es) claimed, (b) to obtain a financial benefit, and (c) in loan transactions an actual financial benefit for the dishonest employee having a value in excess of $2,500.00, were clear and unambiguous and had to be met in fact to satisfy the requirements of coverage as to each of the loans at issue.

D. FINANCIAL BENEFIT

In relation to loan losses contained in Insuring Agreement (A), an additional limitation is imposed before coverage will be found.[49] The 1986 Financial Institution Bond form states that:

> "if some or all of the Insured's loss results directly or indirectly from Loans, that portion of the loss is not covered unless the Employee was in collusion with one or more parties to the transactions and has received, in connection therewith, a financial benefit with a value of at least $2,500."
>
> "As used throughout this Insuring Agreement, financial benefit does not include any employee benefits earned in the normal course of employment, including: salaries, commissions, fees, bonuses, promotions, awards, profit sharing, or pensions."[50]

This restriction was in response to cases construing the financial benefit prong of dishonesty losses as allowing coverage whenever anyone, including the borrower, received a financial benefit from the employee's actions.[51] The additional restriction bars coverage for most lender claims arising out of faulty business judgment or negligent credit or collection decisions by a loan officer rather than the employee's intent to obtain a personal financial benefit.[52] Because the finding of a financial benefit and a loss are often related, the discussion of the two is difficult to separate and will at times be intermingled.

An investigation may have to be made into what the employee received to determine if the employee received a "financial benefit" pursuant to the bond language. For example, in First Philson Bank N.A. v. Hartford Fire Insurance Co., the court found that an employee did not receive a financial benefit, because receipt of shares through an employee stock option plan and salary increases and bonuses was part of the normal compensation for the employee.[53]

The recent Eighth Circuit decision in BancInsure, Inc. v. BNC National Bank, N.A appears to require the insured to show the dishonest employee received a financial benefit in connection with each and every loan transaction within a single fraudulent scheme in order to

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[49] Mary Kay Vyskocil, *supra* note 1, at 344.
[50] Surety Association of America, FINANCIAL INSTITUTION BOND, STANDARD FORM 24 (revised to January 1986).
[51] Mary Kay Vyskocil, *supra* note 1, at 344 (citing *see, e.g.,* Liberty National Bank v. Aetna Life & Casualty Co., 568 F.Supp. 860, 868 (D.N.J. 1983)).
[52] Mary Kay Vyskocil, *supra* note 1, at 344 (citing See Neel, *Financial Institutions and Fidelity Coverage for Loan Losses*, XXT TORT & INS. L.J. 590, 609 (Summer 1986); ABA, DIGEST OF BANK INSURANCE, at 70).
[53] 727 A.2d 584 (Pa. Super. 1999).

fully recover its losses under the bond.[54] The decision by the Eighth Circuit could also be interpreted as defining two separate schemes, only one of which resulted in a financial benefit to the dishonest employee and therefore satisfied the manifest intent requirement. Contentions that the insured must prove only that the employee received a financial benefit in connection with the entire scheme that caused the loss, rather than in connection with each separate transaction, must be analyzed closely to determine if the suggested legal authority actually supports that contention under Insuring Clause (A).

Some cases may speak only in terms of a single embezzlement "loss" or "scheme" for purposes of the Limit of Liability under the Bonds without addressing coverage under Insuring Clause (A). For example, the case of Business Interiors, Inc. v. Aetna Casualty and Surety Company could be mistakenly interpreted to support such proposition, but the 10th Circuit did not discuss Insuring Clause (A) at all throughout its opinion. In the Business Interiors, Inc. case, an employee embezzled $53,036.86 from Business Interiors, Inc. by writing forty checks, thirty-one of which were forgeries and nine that were material alterations of the original instruments.[55] Business Interiors, Inc. argued that it suffered forty separate and independent losses because the employee's embezzlement was accomplished through forty separate checks.[56] The 10th Circuit ruled that the cause of Business Interiors' loss was the continued dishonesty of one employee, and that the probable intent of the employee with regard to the last thirty-nine checks was essentially the intent to continue the dishonesty, not to commit an entirely new and different act of dishonesty.[57] As such, the employee's fraudulent acts constituted a single loss under the bond for purposes of the Limit of Liability.

Similarly, in the case of Kinzer v. Fidelity & Deposit Company of Maryland, the insured argued that the employer sustained a recoverable "loss" each time an illegal expenditure was made, but the Court declined to equate the term "loss" as used in the bond to each illegal expenditure.[58] Once again, an employee's fraudulent acts constituted a single loss for purposes of the Limit of Liability only, but the Court did not address the "financial benefit" requirement of Insuring Clause (A).

If the logic of these cases was extended to each insuring clause contained in the Financial Institution Bonds, then, for example, only one suspect transaction out of an entire "scheme" needs to meet the specific criteria set out in each insuring clause. Insuring Agreement (D) of the Financial Institution Bond, Standard Form No. 24, addresses loss caused by forgery or alteration. If only one transaction needs to meet the specific criteria, the insured would be able to recover all of its losses under Insuring Agreement (D), since the scheme constitutes a single loss for purposes of the Limitation of Liability. This is not what the financial institution bond was designed to cover; it was designed to cover specific losses which meet the detailed requirements of the various Insuring Agreements.

Insuring Agreement (A) does not cover losses other than embezzlement.[59] However, other provisions often cover losses that are not caused by embezzlement, i.e. Insuring Agreement (B), which addresses losses caused by on-premises burglary, robbery and

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[54] 263 F.3d 766 (8th Cir. 2001).
[55] 751 F.2d 361, 362 (10th Cir. 1984).
[56] *Id.*
[57] *Id.* at 363.
[58] 652 N.E.2d 20, 25-26 (Ill.App.Ct. 1995).
[59] General Analytics Corporation v. CNA Insurance Company, 86 F.3d 51 (4th Cir. 1996).

misplacement. But, in order for coverage to exist under the dishonest employee insuring clause only (Insuring Agreement (A), the insured must prove that the dishonest employee embezzled money, i.e. received a financial benefit, in connection with each transaction, if it wishes to fully recover its alleged losses under the Financial Institution Bond.

The principles of the previously discussed case of BancInsure, Inc. v. BNC are applicable here. Although a BNC employee approved numerous loans and lines of credit to a customer that were insufficiently secured and were not repaid, only two loan transactions reflected a manifest intent on the employee's part to cause harm to BNC since funds from those two transactions were used to benefit a company owned by the BNC employee.[60] In other words, the insurer was not liable for the entire fraudulent scheme under Insuring Agreement (A) even though the dishonest employee had received a financial benefit. The Eighth Circuit seemed to divide the loan transactions into separate schemes, and found the bonding company was only liable for those specific transactions, i.e. the portion of the fraudulent scheme, which financially benefited the dishonest employee.

To sum up, an insured can only recover its claimed losses under Insuring Clause (A) if it can prove the dishonest employee acted with the manifest intent to cause the insured a loss and if the dishonest employee obtained a financial benefit in connection with each of the transactions within a singular scheme presented in its claim against the bonding company.

E. CAUSATION

Causation is another element required in order to have a claim under Insuring Agreement (A). First National Bank of Louisville v. Lustig analyzes the manifest intent requirement of Insuring Agreement (A) combined with the requirement that loss, to be covered, results directly from the dishonesty or fraud of the employee.[61] In the Lustig case, the court refused to rely solely on a withdrawn guilty plea as conclusive proof of coverage under Insuring Agreement (A), saying that such was only evidence, perhaps powerful, but clearly not the only evidence of intent.[62] The court held that "[a] loss is directly caused by the dishonest or fraudulent act within the meaning of the Bond where the bank can demonstrate that it would not have made the loan in the absence of fraud." However the court also added that the bond "did not require the bank to rule out all reasons the loan was not repaid before it [could] obtain coverage."[63] The employee in this case dishonestly and fraudulently obtained several real estate loans. The loans thereafter failed and the bank filed a claim under the bond. The court rationalized that just because the loss had been "caused" by a general decline in real estate values in addition to a dishonest or fraudulent act, the insurer could not use the uncovered causes as a defense.[64]

United States Fidelity and Guaranty Co. v. Empire Sate Bank similarly presents the issue of multiple causes of a loss.[65] The court held that where real estate securing a dishonestly obtained loan had a subsequent decline in the collateral's value due to a corresponding decline in the real estate market, the decline in value was not a defense for the

[60] *Id.* at 771.
[61] 961 F2d 1162 (5th Cir. 1992).
[62] 961 F2d 1162, 1165 (5th Cir. 1992).
[63] 961 F2d 1162, 1167 (5th Cir. 1992).
[64] Peter I. Broeman, *supra* note 1, at 447.
[65] 448 F.2d 360 (8th Cir. 1971).

insurer.[66] One author critical of this decision has questioned whether the loss resulted from dishonesty.[67] Lustig is the first case subsequent to Empire State Bank to consider this issue, and uses this multiple cause analysis for this frequently litigated issue.[68]

F. DIRECT LOSS

In most fidelity bonds, the term "loss" is undefined.[69] Since 1976, Standard Form No. 24 has limited fidelity coverages under Insuring Agreement (A) to "losses resulting directly from" employee dishonesty.[70] However, a few courts have seemingly ignored the "direct" requirement.[71] Some cases have held that the bond insures against two kinds of losses: 1) direct loss to the insured via embezzlement, theft, fraud, or the like and 2) an indirect loss to the insured because of liability to a third party.[72] The trend, however, is to limit loss to direct losses[73] and restrict the number of third party claims.[74] This requirement differentiates the bond as a first party insuring agreement from a third party liability policy.[75] As such, it becomes an issue in many cases to determine what is or is not covered as a direct loss. The fidelity bond language of 'losses directly resulting from …' indicates that that insured is covered only for direct losses such as the actual depletion of bank funds due to the employee's dishonesty.[76] In this sense, direct loss exists where there is actual loss to the policyholder rather than a third party.[77]

It has been held that the existence of a loss is a separate consideration from the amount of the loss.[78] For example, direct loss can include loss resulting from depreciation of collateral securing a fraudulently issued loan and occurs "regardless of the security the bank has for the loss."[79] While the value of the collateral may affect the amount of the loss, its existence does not define the loss. Accordingly, even the depreciation in stock held as security will qualify as a loss.[80]

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[66] Peter I. Broeman, *supra* note 1, at 448 citing 448 F.2d 360 (8th Cir. 1971).
[67] Peter I. Broeman, *supra* note 1, at 448 (citing J.F. KRUGER, *Conditions to Recovery: Loss and Causation*, FINANCIAL INSTITUTION BONDS, Vol. 1, Sec. K at 11 and 41, n. 22 (A.B.A. 1992)).
[68] Peter I. Broeman, *supra* note 1, at 449.
[69] Robert M. Horkovich et al., *supra* note 7, at 372.
[70] Mary Kay Vyskocil, *supra* note 1, at 348.
[71] Mary Kay Vyskocil, *supra* note 1, at 344 (citing *see, e.g.,* French American Banking Corp. v. Flota Mercante Grancolombiana, S.A., 609 F.Supp. 1352 (S.D.N.Y. 1985)).
[72] Mary Kay Vyskocil, *supra* note 1, at 340 (citing *see,* e.g., Jefferson Bank & Trust Co. v. Central Surety & Insurance Corp., 408 S.W.2d 825 (Mo. 1966)).
[73] *See, e.g.,* Commercial Bank of Bluefield v. St. Paul Fire & Marine Insurance Co., 336 S.E.2d 552 (W. Va. 1985); Omaha Bank for Cooperatives v. Aetna Casualty & Surety Co., 207 Neb. 782, 301 N.W.2d 564 (Neb. Sup. Ct. 1981).
[74] *See, e.g.,* Commerical Bank of Bluefield, 336 S.E.2d 552; Omaha Bank for Cooperatives, 207 Neb. 782, 301 N.W.2d 564; Ronnau v. Caravan Int'l. Corp., 205 Kan. 154, 161, 468 P.2d 118, 123-24 (1970).
[75] Mary Kay Vyskocil, *supra* note 1, at 348 (citing Bank of Mead v. St. Paul Fire& Marine Insurance Co., 202 Neb. 403, 275 N.W.2d 822 (1979)).
[76] Robert M. Horkovich et al., *supra* note 7, at 372 (citing United Pac. Ins. Co., 20 F.3d at 1080 (citing First Am. State Bank v. Continental Ins. Co., 897 F.2d 319, 325 (8th Cir. 1990) (holding that their was a "loss" resulting from fraudulent loans transactions arranged by bank president where loan proceeds were transferred to third parties)).
[77] Robert M. Horkovich et al., *supra* note 7, at 372.
[78] *See* Savings Bank v. Massachusetts Bonding & Insurance Co., 174 N.E. 324, 328 (Mass. 1931).
[79] Robert M. Horkovich et al., *supra* note 7, at 373 (quoting FDIC v. United Pacific Insurance Co., 20 F.3d 1070, 180-81 (10th Cir. 1994)).
[80] United States Fidelity & Guaranty Co. v. Empire State Bank, 448 F.2d 360, 367 (8th Cir. 1971).

As indicated above, sometimes courts find that direct loss will also include loss to third parties; an insured's obligations to third parties may be protected under fidelity bonds where an employee's dishonesty victimizes such third parties who hold an insured vicariously liable.[81] Note, however, when fidelity bonds include third-party loss payees who are to receive payment for fidelity claims, the loss payee has an independent right of suit against the insurer and the insured does not have a claim for itself under such provision.[82] Even those cases disallowing fidelity coverage for certain types of third party losses will often indicate that coverage may be granted for other kinds of losses involving third parties.[83]

G. EXCLUSIONS

There are several exclusions under the Financial Institution Bond that must be carefully examined to see if they apply to the facts in issue.[84] These exclusions disallow bond coverage for losses where coverage is triggered but then excluded under the bond. One such example is the trading loss exclusion.[85] Trading loss exclusions, like all exclusions, are often viewed narrowly so as to prevent frustration of the purpose behind employee dishonesty bonds.[86] Another exclusion is for loss of "potential income" including, but not limited to, interest and dividends not realized by the insured.[87] The "potential income exclusion" unambiguously excludes interest the insured may have received from coverage under the bond.[88] An insurer is not accountable to the insured for any income loss suffered as a consequence of fraudulent or dishonest acts of its employees.[89]

The majority rule was recognized by the Iowa Supreme Court in American Trust & Savings Bank v. U.S. Fidelity & Guaranty Co. The Court held that the insurer is not required to pay that portion of the face amounts of outstanding notes that represent interest incurred on prior fraudulent notes.[90] The court pointed out that the bond provides indemnity for "[l]oss resulting directly from dishonest or fraudulent acts of an [e]mployee." The court went on to say that the term "loss" under the bond refers to the actual depletion of bank funds caused by the employee's dishonest acts and not to the eventual personal liability of the employee to the bank.[91] In other words, the covered loss is that which arises at the time and place that the

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[81] Robert M. Horkovich et al., *supra* note 7, at 375.
[82] Robert M. Horkovich et al., *supra* note 7, at 376 (citing Dyer v. Great E. Ins. Co., 342 N.Y.S.2d 807, 807-08 (App. Div. 1973) and Pawlick v. New Jersey Auto. Full Ins. Underwriting Ass'n, 666 A.2d 186 (N.J. Super. Ct. App. Div. 1995)).
[83] Robert M. Horkovich et al., *supra* note 7, at 377.
[84] John P. Connelly, Esq. et al., *supra* note 8, at 394.
[85] Robert M. Horkovich et al., *supra* note 7, at 378.
[86] Robert M. Horkovich et al., *supra* note 7, at 378.
[87] John P. Connelly, Esq. et al., *supra* note 8, at 394.
[88] First American State Bank v. Continental Insurance Company, 897 F.2d 319, 329 (8th Cir. 1990).
[89] Diversified Group, Inc. v. Van Tassel, 806 F.2d 1275, 1278 (5th Cir. 1987).
[90] 439 N.W.2d 188 (Iowa 1989).
[91] *Also see* Fireman's Fund Insurance Company v. Special Olympics Intern., Inc., 249 F.Supp.2d 19 (D.Mass. 2003) (insured charity did not suffer "direct loss" within meaning of fidelity policies when employee conducted unauthorized fundraising campaign and kept donations for his personal use, as no funds were taken from any of charity's authorized accounts and its assets were not diminished); FDIC v. United Pacific Ins. Co., 20 F.3d 1070, 1080 (10th Cir. 1994) (under fidelity crime bonds, direct loss means the actual depletion of bank funds caused by an employee's dishonest acts, and therefore, bookkeeping and other theoretical losses not accompanied by actual withdrawals of cash or other such pecuniary loss are not recoverable); Continental Casualty Company v. First National Bank of Temple, 116 F.2d 885, 886-87 (5th Cir. 1941) (in order to trigger coverage, the assets of the insured must be diminished as a result of the dishonest act of the insured's employee); Fidelity & Deposit Company of Maryland v. USAFORM Hail Pool, Inc., 763 F.2d 4, 6-7 (5th Cir. 1972) (finding no loss where

specified misconduct occurred.[92] The bond is intended to cover loss defined as “depletion of the Insured’s assets” and is limited to loss resulting directly from a dishonest act.

Looked at in another light, the concept is that once embezzlement occurs, there is no actual loan. Rather, the initial phony “loan” is just the embezzlement by another term and any subsequent payments to the bank merely represent repayment of the embezzled funds. The bond does not cover interest on embezzlement schemes and hence does not cover any interest income.

III. CONCLUSION

In conclusion, Insurance Agreement (A), while straightforward, is subject to much litigation. For a proper interpretation of its terms, one must turn to the appropriate jurisdiction, because the decisions from jurisdiction to jurisdiction may vary widely. This introduction of its elements should make evident that the bond is not an expression of the insurer’s intent to take on every business risk associated with banking, but rather it only protects financial institutions from very specific perils.[93]

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offending employee used trust funds to pay insured's debts thereby converting its obligation to pay creditors to an obligation to pay customers whose funds had been diverted; assets of insured bank were neither increased nor diminished)

[92] Citizen’s Bank of Oregon v. American Insurance Company, 289 F.Supp. 211, 214 (D.Ore. 1968); St. Paul Fire and Marine Insurance Company v. Branch Bank and Trust Company, 834 F.2d 416,517 (4th Cir. 1987) (In this case St. Paul agreed only to indemnify the bank for any “[l]oss resulting directly from dishonest or fraudulent acts of an Employee committed alone or in collusion with others”; this provision of the bond was not addressed in the court’s opinion. Instead, the court relied solely on the “potential income exclusion” in holding that the bank was not prevented from recovering the entire principal amount owing on a bank employee’s fictitious loans, even though the loans were used in part to repay interest on earlier loans. *Id.* at 418. In light of the other authorities cited herein, we believe this case was wrongly decided due to the failure of the court to recognize that capitalization of the interest accrued on the original “bad” loans in new “bad” loans having principal amounts

which included the unpaid principal amounts and the unpaid accrued interest on the original bad loans did not, to the extent of such inclusions, further deplete the Insured bank's assets).

[93] Peter I. Broeman, *supra* note 1, at 465.

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Biographical Sketch

Bernard A. Reinert is a principal shareholder, the Chairman and the President of the St. Louis law firm, Reinert & Rourke, P.C. The firm is engaged in the general practice of law. Its practice includes insurance coverage litigation, civil litigation arising out of property and casualty claims, subrogation claims litigation, medical malpractice litigation, products and general liability litigation and commercial litigation including particularly, but not limited to, franchise litigation. The firm specializes in fidelity bond, surety bond and construction contract matters.

Mr. Reinert was admitted to the Bar in Missouri in 1962 and in Illinois in 1963. He attended undergraduate school at St. Mary's Mission Seminary College at Techny, Illinois and at St. Louis University in St. Louis, Missouri, and graduated with a Bachelor of Arts degree in 1958. He graduated from St. Louis University School of Law in 1962 with a Bachelor of Laws degree. He was a law clerk to the United States District Judge Omer Poos in Springfield, IL in 1962-1963.

Mr. Reinert is a member of the American Bar Association, the Missouri Bar, the Illinois State Bar Association, and the Bar Association of Metropolitan St. Louis. He has been a member of the Torts and Insurance Practice Section and of the Fidelity and Surety Law Committee for approximately thirty years. He has served several terms as a Committee Vice-Chairman. He has participated in many of the Committee's programs, chaired a program in San Francisco, and presented papers at more than a dozen industry programs. A notable paper which Mr. Reinert has authored I entitled "Duty of the Performing Surety to Bond Principal and Indemnitors: Good Faith". Another paper that he presented to the Committee dealt with the surety rights in subrogation to bonded contract funds before and after the Federal Tax Lien Act of 1966. Mr. Reinert has participated in other activities of the Committee including the Commercial Blanket Bond National Institute, and the Financial Institution Bond National Institute (London, 1992) and the Commercial Blanket Bond Annotation Project. He has participated in updating the Banker's Blanket Bond Annotation. He has participated in the publication of the Fidelity and Surety News (FSN) under the editorial sponsorship of St. Louis University School of Law. He served as the FSN Subcommittee's liaison to the FSN Editor, Professor Donald King. Mr. Reinert participated in the "Subrogation Project" culminating in the August, 1990 ABA Annual Meeting Program of the Fidelity and Surety Law Committee entitled "The Subrogation Rights of the Contract Bond Surety" presenting a paper entitled "elements of Proof in the Contract Bond Surety's Subrogation Action to Recover the Bonded Contract Funds". Mr. Reinert and his firm have participated in the Northeast Surety and Fidelity Claims Conference for many years.

Mr. Reinert lives in the St. Louis suburban community of Kirkwood and has been active in community affairs there, particularly as a member of the Kirkwood R7 School District Board for 15 years, 1976 to 1991. He presently serves as Chairman of the City of Kirkwood Civil Service Commission.

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Lauren D. Reeves joined the firm of Reinert & Rourke, P.C. in May of 1999 as an associate, and is currently affiliated with the firm as "Of Counsel". Her practice emphasizes fidelity and surety bond claims and litigation, construction litigation, and commercial litigation. She received her bachelor of science and bachelor of arts degrees in business administration from Northeast Missouri State University (now Truman State University) in 1996. Ms. Reeves is a graduate of St. Louis University School of Law where she received her Certificate in Employment Law.

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Renee A. Auderer began working as a law clerk for the firm of Reinert & Rourke, P.C. in September of 2002. She received her Bachelor of Science degree in Microbiology with Honors from the University of Iowa in 2000. Ms. Auderer will be earning her Juris Doctorate from Saint Louis University School of Law in 2004 and anticipates receiving a Certificate in Health Law. Ms. Auderer is a member of Phi Alpha Delta, the St. Louis University Women's Law Student Association, and the Health Law Association.

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Thomas H. McNeill, a claim attorney in the Professional E&O group of the St. Paul Companies, has years of insurance experience. He started as a multi-line claims adjuster while in college at the University of Minnesota. After graduating with degrees in Business Administration and Sociology, he went on to law school at William Mitchell College of Law where he graduated with Cum Laude honors. He became an active litigator of insurance issues with the defense firm of Cousineau, McGuire and Anderson in Minneapolis, eventually becoming a shareholder. He then spent six years as a private mediator in The Resolution Group, P.A. His peers have recognized his skills; he has achieved an AV rating. Tom works in all areas of the Professional E&O unit, concentrating in financial bonds.

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A claim attorney in the Professional E&O Specialty Claim unit for The St. Paul Companies, Ms. Gooley's primary responsibilities include claim handling for Financial Institution Bonds. She also handles claims in the areas of Directors & Officers, Employment Law and Lawyers Professional Liability.

Prior to joining The St. Paul Companies, Ms. Gooley was an attorney with the Minneapolis law firm of Meagher & Geer where she worked in the Insurance coverage group and did litigation. In addition, she has also held a position with the Minnesota Department of Commerce and clerked for current Chief Justice Kathleen Blatz and Justice Joan Lancaster of the Minnesota Supreme Court. Ms. Gooley earned her degree in Finance and political science from the University of Minnesota Carlson School of Management and graduated with honors from Drake University Law School. She is a member of the Wisconsin Bar Association and the Minnesota State Bar Association.