FIFTEENTH ANNUAL
NORTHEAST SURETY AND FIDELITY CLAIMS CONFERENCE

SEPTEMBER 30 - OCTOBER 1, 2004

MAKING SENSE OF THE EMPLOYEE BENEFIT EXCLUSION IN THE MANIFEST INTENT CLAUSE

PRESENTED BY:

GARY M. CASE, ESQ.
WOLF, HOROWITZ, ETLINGER & CASE, LLC
99 Pratt Street, Suite 401
Hartford, CT 06103
Phone: (860) 724-6667
Facsimile: (860) 293-1979
Email: gcase@wolfhorowitz.com

Making Sense of the Employee Benefit Exclusion in the Manifest Intent Clause

I. Introduction

Fidelity bonds and commercial crime policies typically contain a "manifest intent" clause. The purpose of this clause – from the perspective of the insurer – is to limit and narrow coverage to the "paradigmatic" cases of embezzlement and employee theft.

This clause is relatively unique in the realm of insurance, in that it sets forth a limitation of coverage which is determined by the "intent" of an individual. Most insurance policies include terms and limiting provisions which are clearly verifiable in relation to a known (or knowable) fact – i.e., the value of property or the occurrence of a specific event. Coverage determinations in these instances are generally a straightforward exercise – Was there an accident during the policy period? Did it involve the insured? Was there damage to person or property? What it the economic value of these damages?

In contrast, coverage under fidelity bonds and commercial crime policies is triggered by reference to the "intent" of an employee. Determination of an employee's "intent" is often not a straightforward exercise. An employee may have many motivations for taking a particular action. An employee's stated motivation for engaging in certain conduct may be untrue. Or, the employee may have mixed motives.

This clause presents a greater challenge to the fidelity claims professional because of the "employee benefit exclusion" included in the second half of the manifest intent clause. Essentially, this provision provides a further limitation on coverage by requiring the insured to prove that the dishonest employee intended to obtain a financial benefit, for himself and others, other than employee benefits earned in the normal course of employment, including: salaries, commissions, fees, bonuses, promotions, awards, profit sharing or pensions.

This "employee benefit exclusion"[1] has generated litigation concerning some of the following issues: What it the significance of the term "earned in the normal course of employment"? What "benefits" qualify as "employee benefits earned in the normal course of employment"? What happens if an employee uses dishonest or fraudulent means with the intent of obtaining commissions, bonuses or extra salary? Are these benefits earned in the "normal course of employment"? Do "one-time-payments" qualify? What happens if the employee intends to obtain a benefit which he could never have actually received? Must the employee actually receive the benefit? What happens if the employer unwittingly makes excessive "salary" payments to the employee, which the employee never returns? Also, is the "employee benefits exclusion" truly an "exclusion", or is it instead a condition precedent to coverage? As between the insured and the insurer, which has the burden of proving that the employee had (or lacked) the requisite intent to obtain the benefit?

---

[1] For ease of reference this paper will generally refer to the clause as the "employee benefits exclusion". However, it is probable that the clause is a limitation on coverage, and not an "exclusion", as these terms are generally understood in insurance coverage law. See infra, § IIE.

Section II of this paper will discuss the cases addressing many of these issues. Section III will provide a brief summary.[2]

II. Caselaw and Analysis

The typical "manifest intent" clause in a fidelity bond or commercial crime policy provides as follows:

> "Employee dishonesty" … means only dishonest acts committed by an employee, whether identified or not, acting alone or in collusion with other persons, except you or your partner, with the manifest intent to:
>
> (1) Cause you to sustain a loss; and also
> (2) Obtain financial benefit (other than employee benefits earned in the normal course of employment, including: salaries, 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.

On its face, this provision requires proof that the dishonest employee not only intended to cause a loss to the insured, but also intended to obtain a financial benefit for himself or others. However, the intended benefit must not be one of the defined categories of benefits earned in the normal course of employment. This seemingly straightforward clause has generated a good deal of litigation, most of which is favorable to the fidelity insurer.

A. ***Resolution Trust Company v. Fidelity & Deposit Company of Maryland* – "earned in the normal course of employment" *limits* coverage, does not *expand* coverage.**

By far the most extensive and reasoned discussion of this clause is contained in the Third Circuit Court of Appeals decision in Resolution Trust Company v. Fidelity & Deposit Company of Maryland, 205 F.3d 615 (3rd Cir. 2000) ("RTC"). This case can generally be cited for the following propositions: (1) the inclusion of the term "earned in the normal course of employment" does not expand coverage – consistent with the overall purpose of the manifest intent clause, its presence is a further limitation of coverage; (2) the exclusion applies, and thus the claim is not covered, even if the employee intends to use dishonest or fraudulent means to obtain salary or other employee benefit – thus employee benefits earned dishonestly or by fraud are excluded from coverage; (3) the exclusion can apply to "one-time-payments", and the intended benefit need not have been of the type regularly

[2] For other papers discussing some of these same issues, see David T. Knight, "Manifest Intent and the Financial Benefit Requirement in Insuring Agreement A", Southern Surety and Fidelity Claims Conference, St. Pete Beach, Florida, April 15-16, 2004, and Charles M. Armentrout and Jeffrey S. Price, "Financial Benefit Requirement (Including Discussion of Employee Salary, Commissions and Fees Exclusion)", ABA Fidelity and Surety Annual Mid-Winter Meeting, January 24-25, 2002, New Your, New York;

conferred on the dishonest employee.

This case arose out losses relating to a mortgage warehouse lending operation. The RTC made a claim on the fidelity bond based on the alleged concealment of information regarding non-performing loans by the dishonest employees. According to the RTC the scheme satisfied clause (2) of the manifest intent provision because the dishonest employees had negotiated "golden handcuff" payments in connection with the proposed sale of the mortgage warehouse lending operation to a third party. The employees had also allegedly negotiated for lucrative employment arrangements with the purchaser of the mortgage warehouse lending operation after the sale was completed.

The RTC argued that these payments and employment opportunities were not financial benefits earned in the "normal course of employment", thereby precluding the invocation of the exception to coverage set forth in the manifest intent clause. Specifically, the RTC argued that the "golden handcuff" payments were "one time only" payments which, of necessity, could not have been earned "in the normal course of employment". In support of this argument, RTC contended that the "employee benefits" contemplated by the manifest intent clause included only "payments which are generally received on a regular basis as part of an employee's compensation scheme." RTC, 205 F.3d at 645. The RTC also argued that the manifest intent clause was ambiguous with respect to whether the phrase "normal course of employment" was intended to include "one time only" compensation payments made by the employer to the employee. Applying the rule of contra proferentem (construing ambibuities in insurance policies against the insurer), the RTC argued that a "one time only" payment, even if knowingly made by the employer as compensation for the employee, cannot be considered as a payment made "in the normal course of employment."

In response, F & D (the insurer) argued that "Courts uniformly have construed the Bond's exclusion language for financial benefits to mean any payment that the insured voluntarily pays to an employee, even if those payments are fraudulently earned," and "recovery under a fidelity bond is barred if the employer 'knowingly paid the disputed funds directly to the employees on the belief that the employees were entitled to the payments as compensation for honest work'." RTC, 205 F.3d at 646.

The Third Circuit Court of Appeals rejected most of the arguments made by RTC, and held that the "handcuff payments fall squarely within the definition of bonuses or awards, or alternatively qualify as a type of benefit earned in the normal course of employment." Id. In a lengthy and persuasive analysis, the Court discussed the proper construction and interpretation of the "normal course of employment" provision in the manifest intent clause. As a matter of contract interpretation, the Court concluded that the term "earned in the normal course of employment" was intended to modify the term "other employee benefits." This is so because of the location and proximity of the terms in the policy, together with the fact that there are no commas between the phrases, thereby suggesting that they must be read together. Therefore, the term "earned in the normal course of employment" modifies only the general phrase "other employee benefits" rather than the other specific types of employee benefits enumerated in the clause. See RTC,

205 F.3d at 646. This term was incorporated into the policy as a means of limiting coverage by broadening the scope of the exclusion.

The Court then considered, and expressly rejected, RTC's argument that a "one time only" payment such as the "golden handcuff" payment made in this case would render inapplicable the exclusion set forth in section (2) of the manifest intent clause. Instead, the Court opted for a more functional interpretation of the clause: "Extrapolating from the cases we have found on point, we understand the exclusion found in subsection (b) to eliminate coverage where the insured's theory is that the employee's purpose in engaging in the misconduct that caused the loss was to receive some type of financial benefit that, generally speaking, the insured provides knowingly to its employees as part of its compensation scheme and as a result of the employment relationship." RTC, 205 F.3d at 647. [3]

The Court reasoned that the phrase "normal course of employment" references the

[3] In support of this interpretation, the Court cited the following cases: *Federal Deposit Ins. Corp. v. St.Paul Fire & Marine Ins. Co., 738 F. Supp. 1146, 1990 U.S. Dist. LEXIS 6313 (M.D. Tenn. 1990);* (reviewing cases finding that coverage was precluded by the exclusionary clause, and noting that in each of them, "the employers [i.e., the insureds] knowingly paid the disputed funds directly to the employees on the belief that the employees were entitled to the payments as compensation for honest work"); *Glusband v. Fittin Cunningham & Lauzon, Inc., 892 F.2d 208, 1989 U.S. App. LEXIS 19369 (2d Cir. 1989)* (affirming judgment for insurer and noting that there was no evidence that the dishonest employee ever received any financial benefit other than salaries or commissions from insured, his employer, as a result of improper and speculative trading practices); Municipal Sec., Inc. v. Insurance Co. of N. Am., 829 F.2d 7, 9-10 (6th Cir. 1987) (affirming summary judgment for insurer where only evidence was that the employee obtained additional, unearned commissions from insured, her employer, as a result of improper conduct); *Auburn Ford Lincoln Mercury v. Universal Underwriters Ins. Co., 967 F. Supp. 475, 1997 U.S. Dist. LEXIS 9194 (M.D. Ala. 1997)* (same conclusion), aff'd 130 F.3d 444 (11th Cir. 1997) (table); *Hartford Acci. & Indem. Ins. Co. v. Washington Nat'l Ins. Co., 638 F. Supp. 78, 1986 U.S. Dist. LEXIS 25842 (N.D. Ill. 1986);* (stating that the last phrase "or other employee benefits earned in the normal course of employment" serves the useful purpose of distinguishing the entire list in part (b) from those financial benefits that, generally speaking, are "unearned" in the sense that they are not paid by the employer to the employee as part of the compensation scheme, but instead are obtained from payoffs, embezzlement schemes and other forms of theft); Verex Assurance, Inc. v. Gate City Mortgage Co., 1984 U.S. Dist. LEXIS 21545, No. C-83-0506W, 1984 WL 2918, at *1-2 (D. Utah Dec. 4, 1984) (granting judgment to insurer because there was no evidence that employees intended to obtain a covered financial benefit; court noted that the proofs indicated only that the loan officers decided to make loans to persons of questionable credit in order to collect commissions on the loans from their employer, the insured); Mortell v. Insurance Co. of N. Am., 120 Ill. App. 3d 1016, 458 N.E.2d 922, 929, 76 Ill. Dec. 268 (Ill. App. Ct. 1983) (finding that dishonest employees' only personal gain was improper commissions received from insured); Benchmark Crafters, Inc. v. Northwestern Nat'l Ins. Co., 363 N.W.2d 89, 91 (Minn. Ct. App. 1985) (stating that employee's four months of salary and benefits he received as an employee of the insured before the insured's discovery of the fraud did not provide basis for coverage); First Philson Bank, N.A. v. Hartford Fire Ins. Co., 1999 PA Super 51, 727 A.2d 584, 590 (Pa. Super. Ct. 1999) (affirming summary judgment for insurer and holding that employee's receipt of shares of insured's stock through an employee stock option plan, along with various salary increases and bonuses from insured, constituted receipt of benefits "earned in the normal course of employment"), appeal denied, 1999 Pa. LEXIS 3786, 1999 WL 1255735 (Pa. Dec. 27, 1999); Dickson v. State Farm Lloyds, 944 S.W.2d 666, 668 (Tex. App. 1997, no writ) (rejecting insured's coverage claim based on loss caused by employees' manipulation of time card system in order to obtain extra salary from insured); cf. James B. Lansing Sound, Inc. v. National Union Fire Ins. Co., 801 F.2d 1560, 1567 (9th Cir. 1986) (holding, in a suit for recovery on an employee dishonesty policy under which the insurer agreed to indemnify for loss of money, securities, or "other property" the insured sustained because of employee dishonesty, that the term "other property" did not permit the insured to recover commissions which it paid to an employee on fraudulent sales; court relied on language in dishonesty clause that excluded "commissions . . . or other benefits earned in the normal course of employment").

"character of the payment at issue rather than the frequency with which the payment is received or the timing of its receipt." Id. at 648. A bonus, by its very nature, may be provided only one time during an employee's career. Therefore it would make little sense to construe the phrase "in the normal course of employment" as excluding "one time only" payments, since such a construction would render the term "bonus" in clause (2) internally inconsistent. Instead, the Court concluded that the exclusion "covers payments knowingly made by the insured to the employee as a consequence of their employment relationship and in recognition of the employee's performance of job-related duties." Id. at 649. Payoffs, bribes or kickbacks would fall outside of the exclusionary clause, and would not be considered as payments earned in the "normal course of employment." Id.

Applying this standard, the RTC Court held that the "golden handcuff" payments made to the dishonest employees qualified as a payment made in the normal course of employment, as contemplated by clause (2) of the manifest intent provision. The evidence demonstrated that the payments were made in recognition of job-related performance. Moreover the payments were made in a lump sum, which was indicative of a bonus payment. As such, the Court concluded that the RTC could not proceed with a claim based on a theory that the dishonest employees intended to obtain the "golden handcuff" payments as a benefit of employment, since these payments were in the nature of a bonus or other benefit earned in the normal course of employment.

However, the Court further held that RTC could pursue a separate claim based on the theory that the dishonest employees had intended to obtain a financial benefit in the form of lucrative employment opportunities with third parties and future prospective employers. RTC, 205 F.3d at 650.

B. Unauthorized pay increases, employee manipulation of payroll, and clandestine "salary" payments.

A fidelity insurer may be presented with a claim that a dishonest employee engaged in a scheme to defraud the insured by issuing pay increases to himself without the knowledge or approval of the employer. The employee may manipulate payroll records to conceal the payments. The employee may also issue checks to himself as a form of "salary" or "bonus", again without the consent or knowledge of the employer. The insured may make a claim on its fidelity policy or bond seeking to recoup the payments made to the employee. The fidelity insurer may deny the claim on the basis that the employee intended to obtain a benefit earned in the normal course of employment. Often the insured argues in response that the exclusion does not apply since the payments were not "earned in the normal course of employment", were not made without the knowledge or approval of the insured, and therefore constitute a covered claim of "pure embezzlement". As discussed in the cases summarized below, some courts have found these claims to be excluded from coverage, while others have held them to be covered.

The United States Court of Appeals for the 5th Circuit held that the manifest intent clause excluded coverage for claims of unauthorized pay increases in Performance Autoplex II v. Mid-Continent Casualty Company, 322 F.3d 847 (5th Cir. 2003) ("Performance

Autoplex"). Here an employee of the insured gave herself and another employee unauthorized pay increases of $19,724. The employee failed to secure the approval of management for these increases. The employer submitted a claim for these pay increases under its employee dishonesty policy. The insurer denied the claim on the basis of clause (2) of the manifest intent exclusion. The employer contended that the unauthorized pay increases were neither "earned" nor were they obtained "in the normal course of employment". Performance Autoplex, 322 F.3d at 857.

The Fifth Circuit Court of Appeals agreed with the insurer and held that the manifest intent clause excluded coverage for the salary increases obtained by fraud. The Court rejected the argument that the language of clause (2) is ambiguous. The insured's interpretation of the clause would make sense only if the exclusion applied to salaries and commissions "not obtained through employee dishonesty." Id at. 858. Instead, the language "excluding salaries presumes that there are acts of employee dishonesty that result in increased employee benefits that the insured and the insurer agreed to exclude from coverage." Id. Therefore the fact that the employee obtained the salaries by dishonest means did not render them "unearned" for purposes of clause (2). Indeed, "unearned salaries and commissions are nevertheless still salaries and commissions and therefore belong to the generic category of employee benefits that are normally earned in the normal course of employment." Id. quoting Hartford Accident & Indemnity Ins. Co. v. Washington National Ins. Co., 638 F.Supp. 78 (N.D.Ill. 1986).

The Texas Court of Appeals also considered and rejected a claim for unauthorized salaries in Dickson v. State Farm Lloyds, 944 S.W.2d 666 (Tex App 1997). This was a claim by a physician based upon two employees who had manipulated time cards "in order to obtain extra salary" for work which they never actually performed. Dickson v. State Farm Lloyds, 944 S.W.2d at 668. The insurer argued that the claim was excluded under clause (2) of the manifest intent provision. The insured argued that the manifest intent clause was ambiguous with respect to its coverage for the claim. The Court of Appeals agreed with the insurer and held that the clause was not ambiguous. The Court observed that the general purpose of employee dishonesty coverage was to "protect the employer against such dishonest actions of his employee as embezzling the employer's funds or selling the employer's property for personal gain". Id. The Court observed that courts of other states had uniformly held that "when an employee has dishonestly or fraudulently obtained for himself only salary or other such employee benefits, other courts have held that similarly worded policies unambiguously exclude coverage." Id. citing Municipal Securities, Inc. v. Insurance Co. of North America, 829 F.2d 7, 10 (6th Cir. 1987); James B. Lansing Sound, Inc. v. National Union Fire Ins. Co., 801 F.2d 1560, 1567 (9th Cir. 1986); Benchmark Crafters, Inc. v. Northwestern National Ins. Co., 363 N.W.2d 89, 91 (Minn. App. 1985); Mortell v. Insurance Co. of North America, 120 Ill. App. 3d 1016, 458 N.E.2d 922, 929, 76 Ill. Dec. [**8] 268 (Ill. App. Ct. 1983); cf. First National Bank v. Lustig, 961 F.2d 1162, 1166-67 (5th Cir. 1992) (fact issue existed concerning intent of dishonest employee who falsified loan records either to move ahead at the bank or to obtain benefits aside from advancement or employee benefits).

The Supreme Court of Alabama considered the issue in Cincinnati Insurance Company v. Tuscaloosa County Parking Authority, 827 So.2d 765 (Ala. 2002). Here the

insured was a municipal parking authority. The claim arose out of the actions of two of the Authorities board members. Both were paid salaries at amounts set by the Parking Authority Board of Directors. However these individuals devised a scheme to pay themselves $300,000 in excess of their designated salary. The scheme involved the issuance of payroll checks to the two Board members, without the knowledge or approval of the rest of the Board. Although the checks were signed by a member of the Board, he was unaware of the fraud. The two dishonest Board members concealed the payments until they were replaced and an audit uncovered the fraud. The Parking Authority sought recovery of the payments, and the fidelity insurer denied coverage on the basis that the payments in question were salaries and employee benefits and therefore excluded from coverage under the policy.

The Alabama Supreme Court concluded that the claim was covered even though the payments at issue were issued via payroll checks and under the guise of "salaries". The Court found that the language of the manifest intent clause is not ambiguous. With respect to the term "salaries", the Court referenced the dictionary definition of "fixed compensation for services paid to a person on a regular basis." Cincinnati Insurance Company v. Tuscaloosa County Parking Authority, 827 So.2d at 768. The monies paid to the dishonest Board members could not qualify as "salaries" because they exceeded the amounts which had been fixed as compensation due to the Board members. The Court therefore refused to rewrite the term "salaries" to "designated as salaries." Id. The Court further observed that "none of the embezzled funds were 'earned'; they were 'stolen'. This clause, as read by an ordinary person, draws the distinction between 'employee benefits earned in the normal course of employment' which are not covered by the policy, and things such as embezzlement, kickbacks, payoffs, and general theft, which are." Id.

The Maryland Court of Appeals reached a different result, and refused to follow the reasoning of Cincinnati Insurance Company v. Tuscaloosa County Parking Authority, in ABC Imaging of Washington v. The Travelers Indemnity Company, 820 A.2d 628 (Md.App. 2003). This interesting claim arose out of the following circumstances. The insured owned a printing business. It hired one Miller as an employee, with an agreed-upon annual salary of $29,000. At the start of his employment, a clerk employed by the insured made an error in reporting Miller's salary to the outside payroll company responsible for issuing payroll checks. The clerk reported Miller's weekly pay rate instead of his hourly pay rate. As a result, for the first six weeks of his employment, Miller (unbeknownst to his employer) received checks totaling $54,832.32, or $52,432.32 more than he was otherwise entitled to! Miller cashed the checks and did not tell management. They discovered the error and confronted him. Miller ran from the premises and was never heard from again. The employer made a claim for the overpayment on its fidelity bond, and the insurer denied coverage on the basis that the claim was excluded by the manifest intent clause.

The Court agreed with the insurer and affirmed the granting of summary judgment in favor of the insurer. The Court began its analysis with a general discussion of the purpose of the manifest intent clause. One purpose was for insurers to avoid involvement in "employer-employee disputes about entitlement to salary, commissions, or benefits, for in all such cases the conduct of the employee is within the internal control of the employer."

ABC Imaging of Washington v. The Travelers Indemnity Company, 820 A.2d at 631. The other purpose was to limit coverage for claims, consistent with the intent of the insurance industry and in response to cases which had expanded coverage beyond the paradigmatic claims of theft and embezzlement. Id.

The insured argued that payments made accidentally or erroneously to the employer cannot be considered as "salary" for purposes of the manifest intent exclusion. The Court disagreed. It cited the majority view as excluding coverage "where the only financial benefit gained by the dishonest employee was additional salary or commissions to which the employee was not entitled." Imaging of Washington v. The Travelers Indemnity Company, 820 A.2d at 634. The Court concluded that that the additional monies paid to Miller "were not the result of an overt dishonest act by Miller, but the result of an error by [the insured] or its agent, substituting the weekly pay rate for the hourly rate." Id. at 635. The Court refused to follow the holding and rationale of Cincinnati Insurance Company v. Tuscaloosa County Parking Authority, supra. The Court concluded that the claim was not covered since the policy "unambiguously excludes from coverage the acts of an employee who fraudulently or dishonestly obtains salary or commissions." Id. at 402.

The Supreme Court of New York, Appellate Division, considered a claim arising out of unauthorized payments to an employee in Klyn v. Travelers Indemnity Company, 273 A.D.2d 931, 709 N.Y.S.2d 780 (2000). Here the comptroller of the insured "embezzled funds from a payroll account over which he had sole control by secretly and fraudulently paying himself unauthorized and excessive salary, commissions and bonuses." Klyn v. Travelers Indemnity Company, 273 A.D.2d at 931. The Court held that the claim was covered by the policy, and the lower court erred in finding that it was excluded under the "manifest intent" exclusion. The Court cited with approval the standard set forth in FDIC v. St. Paul Fire & Marine Insurance Co., 738 F.Supp. 1146 (M.D. Tenn. 1990) aff'd in part and vacated on other grounds 942 F.2d 1032 (6th Cir. 1991), that "[w]here the employer does not knowingly pay funds to its employee under the belief that the funds have been honestly earned, but is instead unaware of the employee's receipt of the funds or pays the lost funds for some purpose other than the employee's compensation, the employee has committed pure embezzlement which is recoverable under the [policy]."

C. Commissions on Unauthorized Sales and Fraudulent Transactions

Another common scenario presented to fidelity insurers concerns unauthorized and fraudulent sales and transactions by a dishonest employee. Often the employee is motivated by a desire to obtain commissions on the bogus transaction. The employee may seek to conceal the scheme by using dishonest or fraudulent means. Such claims are generally excluded from coverage under the "employee benefit exclusion" in the manifest intent clause.

The Sixth Circuit Court of Appeals considered the issue of unauthorized commissions and the manifest intent clause in Municipal Securities v. Insurance Company of North America, 829 F.2d 7 (6th Cir. 1987). Here the insured employer was a broker-dealer specializing in the trading of government bonds. One of its employees exceeded her trading limit, causing substantial losses. She concealed this from her employer. As a

result of these unauthorized trades, the employee obtained commissions in the amount of $14,674, to which she would not have been entitled but for the improper trades. The employer made a claim on the employee dishonesty policy for these commissions. The insurer denied the claim because the commissions were employee benefits earned in the normal course of employment. The Sixth Circuit Court of Appeals agreed with the insurer, finding that the claim was excluded by clause (2) of the manifest intent exclusion. The Court expressly rejected the contention that the commissions were obtained by fraud and therefore could not have been earned in "the normal course of employment." Municipal Securities v. Insurance Company of North America, 829 F.2d at 10.

The District Court for the District of Utah considered a similar claim in Verex Assurance Company v. Gate City Mortgage, 1984 WL 2918 (D.Utah 1984). Here three loan officers for a bank perpetrated a fraudulent scheme to secure loans to persons of questionable credit, in order to secure the commissions on these loans. The insurer argued that the loan officers intended only to obtain commissions as a result of this scheme, and therefore the claim was precluded under clause (2) of the manifest intent exclusion. The Court agreed, observing that "[i]n order to constitute fraudulent acts within the meaning of [the policy] there must be a manifest intent by the employee to procure some sort of financial benefit other than salary, commissions, or similar benefits." Verex Assurance Company v. Gate City Mortgage, 1984 WL 2918, 2.

The Ninth Circuit Court of Appeals considered whether fraudulently obtained commissions would be covered under an employee dishonesty policy in James B. Lansing Sound v. National Union Fire Insurance Co. of Pittsburgh, 801 F.2d 1560 (9th Cir. 1986). The insured in this case was a manufacturer and seller of stereo equipment. Two employees of the insured engaged in a fraudulent scheme involving the unauthorized sale of stereo equipment. The dishonest employees used fake invoices and purchase documents to sell the equipment to unauthorized dealers at reduced prices. One of the dishonest employees collected 7% commissions on the fraudulent sales. The insured sought to collect these commissions from the insurer, along with the other losses which it claimed to have incurred as a result of the fraud. The insurer argued that the commission payments were excluded by the exclusion in the manifest intent clause for "salaries, commissions, fees, bonuses, promotions, awards, profit sharing, pension or other employee benefits earned in the normal course of employment." James B. Lansing Sound v. National Union Fire Insurance Co. of Pittsburgh, 801 F.2d at 1567. The insured responded that the fraudulent sales could not have been part of its "normal course of business", and therefore the exclusion did not apply. Id. The Ninth Circuit agreed with the insurer and held that insured could not recover the commission payments. The Court reasoned that under the insured's interpretation of the policy the exclusion of commissions from coverage "would have no meaning or effect because fraud or dishonest acts are not usually part of a normal course of business." Id. In addition, the Court held that the commissions were expenses which the insured would have collected even if the merchandise had been sold at the appropriate price.

It should be noted that while the Court in James B. Lansing Sound v. National Union Fire Insurance Co. of Pittsburgh held that the insured could not recover the commission

payments made to the dishonest employees, the insured could recover for certain other losses sustained by the insured, including the freight payments which the insured was required to make as a result of the scheme. James B. Lansing Sound v. National Union Fire Insurance Co. of Pittsburgh, 801 F.2d at 1566. Therefore, the fact that the dishonest employee intended to obtain commissions, and that such an intent was deemed to be in the "normal course of employment", did not exclude the entire claim from coverage. Instead, the court excluded from coverage that portion of the claim pursuant to which the insured sought recovery for commissions. Id. [4]

In Jamie Brooke v. Zurich American Insurance Co., 298 A.D.2d 145, 748 N.Y.S.2d 5 (2002), the insured was a clothing manufacturer. An employee forged purchase orders, with the intent of securing a bonus because of the bogus sales. The insured manufactured the clothing based on the forged purchase orders, and then discovered the fraud. The insured was able to sell the clothing, but at a loss. The insured sought to recover its losses under its fidelity policy. The insurer argued that the claim was excluded because the employee's intent in preparing the forged purchase orders was to secure a bonus or other employee benefit. The insured responded that the exclusion was not applicable since the insured did not pay its employees bonuses. The Court agreed with the insurer and held that the claim was excluded by the employee benefit exclusion. The Court reasoned that the exclusion did not depend upon whether the employee actually received the benefit, but rather whether the employee intended to obtain the benefit, however erroneous or misinformed that intent might have been. Jamie Brooke v. Zurich American Insurance Co., 298 A.D.2d at 145, citing Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co., 246 A.D.2d 202, 209 *(N.Y. App. Div. 1st Dep't 1998).*

D. Fees and Benefits to Third Parties

The United States District Court for the Middle District of Tennessee construed the "employee benefits" exclusion in a blanket bond in FDIC v. St. Paul Fire & Marine Insurance Co., 738 F.Supp. 1146 (M.D. Tenn. 1990) aff'd in part and vacated on other grounds 942 F.2d 1032 (6th Cir. 1991). This claim concerned, inter alia, $54,000 in payments which had been approved by a dishonest bank officer to a consulting company, as well as $170,000 in "executive committee fees" which had been paid by the bank to the dishonest bank officer. With respect to the consulting company payments, these payments were made without the knowledge of bank officials and the dishonest employee admitted that he attempted to conceal the payments, and had authorized the payments because of his personal indebtedness to the principal of the consulting company. The insurer sought to exclude coverage for these payments on the grounds that they were for "fees" and therefore were excluded under the manifest intent clause.

The District Court disagreed and held that the insurer was entitled to recover all of the payments made to the consulting firm. The Court reasoned that under the caselaw, recovery is barred under the "employee benefits" portion of the manifest intent clause only

[4] In support of its reasoning the Court cited Howard, Weil, Labouisse, Friedrichs v. Insurance Company of North America, 557 F.2d 1055, 1056 (5th Cir. 1977), where the Fifth Circuit affirmed the District Court's finding that the insurer under a fidelity bond was liable for the losses caused by the employee "less the commission the employer would have been obligated to pay the employee were it not for his dishonesty."

where the following conditions are met:

1) The employer knowingly pays funds directly to the employee; and
2) The employee defrauds the employer into believing that the employee has earned the funds as compensation for his work.

FDIC v. St. Paul Fire & Marine Insurance Co., 738 F.Supp. 1146. While the Court recognized that the manifest intent clause "significantly narrows the coverage of the bond, [it] does not wholly negate it." Id. The Court found that the bank did not knowingly authorize or approve of the payments which had been made to the consulting company. Therefore, even though the payments were nominally described as "fees", the payments constituted "pure embezzlement" which were recoverable under the bond. Id.

The Court similarly held that the $170,000 in "executive committee fees" paid to the dishonest employee was also covered by the bond, notwithstanding the fact that they were described as "fees". The bank's Board of Directors had set the officer's annual compensation as $50,000. The Board was unaware of these additional "executive committee fees". Therefore the Board could not have knowingly authorized payments to increase the employee's compensation. For all of these reasons the Court concluded that the "fees" were in fact "pure embezzlement", and thus were covered by the terms of the bond. FDIC v. St. Paul Fire & Marine Insurance Co., 738 F.Supp. at 1161.

In a recent case the Third Circuit Court of Appeals discussed the meaning of the manifest intent exclusion, and in particular clause (2), in Federal Deposit Insurance Corporation v. National Union Fire Insurance Company of Pittsburgh, 2003 U.S. App. Lex. 2096 (3rd Cir. 2003). Here the FDIC as receiver for a failed bank made a claim on a financial institution bond arising out of losses related to defaulted loans issued by the failed bank for a construction project. The FDIC contended that an executive vice president of the bank concealed material information about the bank's customer to the bank's board of directors. The FDIC further contended that the bank executive intended to benefit subcontractors working on the project. The insurer argued that the executive vice president lacked the requisite manifest intent to obtain a financial benefit for himself or a third party. The Third Circuit agreed with the insurer and granted summary judgment for the insurer. The Court identified the following as required elements for any claim under a financial institution bond:

> the following elements [must] be present in order for a loss to constitute a covered event: (1) the insured must incur a loss; (2) the loss must have 'resulted directly' from dishonest or fraudulent acts of an employee or employees; (3) the employee must have committed the acts with the 'manifest intent' to cause the insured to suffer the loss sustained . . .; and (4) the employee must have committed the acts with the 'manifest intent' to obtain a financial benefit for the employee or a third party, and the financial benefit obtained must not be of the type covered by the exclusionary clause.

Id. (emphasis added).

Applying this criteria, the Court concluded that the insured could not satisfy its burden of showing that the executive vice president had the requisite intent to cause a loss and obtain a financial benefit as required by the policy. The Court noted that most of the "concealed facts" were in fact known by other bank executives, and these facts did not demonstrate conclusively that the project was a failure. In addition, while some of the loan proceeds were in fact paid to the subcontractors for "work already completed, this was to assuage the subcontractors, who were threatening to leave the job." Id.

The New Jersey Superior Court held that an insured could not establish the requisite intent to benefit a third party in North Jersey Savings & Loan v. Fidelity & Deposit Company of Maryland, 283 N.J.Super. 56, 660 A.2d 1287 (1993). Here the insured was a bank which acquired high-risk mortgages from a broker/originator. The bank claimed that its senior loan officer acted dishonestly with respect to the loans. The bank conceded that the loan officer did not act with the intent to obtain a financial benefit for himself, but did intend to obtain a financial benefit for the broker/originator in the form of a broker's fee and in profits obtained from the origination and servicing of the loans. The Court held that this was not sufficient because these were fees and payments obtained in the "normal course of their businesses." North Jersey Savings & Loan v. Fidelity & Deposit Company of Maryland, 283 N.J.Super. at 68-69.

An escrow agent's fraudulent transfer of escrowed monies for the benefit of his employer was considered in Estate of Jordan v. Hartford Accident and Indemnity Company, 844 P.2d 403 (Wa. 1993). The insured was an escrow company. The escrow agent was a shareholder, director, vice-president and employee of the escrow company. He diverted funds from the escrow account to his company's operating account. The converted funds were used to pay the operating expenses of the insured escrow company. There was no evidence that any of the embezzled monies were taken by the dishonest employee. The insurer thus argued that the employee benefit exclusion applied and precluded coverage. The Court disagreed, finding that the agent intended to confer a benefit upon his employer in the form of payment of the employer's operating expenses. Some of these expenses represented debts for which the escrow agent had potential personal liability. In addition, the escrow agent's embezzlement allowed the escrow company to remain in business, which benefited the agent in his capacity as a shareholder. For all of these reasons, the Court held that the claim was covered by the bond.

E. Burden of proof issues: is the "employee benefit exclusion" truly an "exclusion"?

Under long-established principles of insurance law, the insured bears the burden of proving that its claim comes within the terms of the policy. However the burden of proof shifts to the insurer to prove that a particular claim is excluded. This often subtle distinction occasionally gives rise to disputes between the insurer and the insured regarding whether a particular term or provision in a policy is an exclusion or a condition to coverage. The outcome of this dispute can impact the litigation by shifting the burden of proof in either direction. Many of the cases addressing the "employee benefits" clause refer to it as an "exclusion" without any extended discussion or analysis. However in one case this issue took on added significance because the allocation of the burden of proof was considered a

significant issue. See Mortgage Associates v. Fidelity & Deposit Company, 105 Cal.App.4th 28 (2002). Here the insured mortgage lender asserted a claim based on a fraudulent scheme arising out of loans. The lender claimed that two of its employees were involved in the scheme and intended to benefit from it. The lender could not produce any direct evidence of that intended benefit. The insurer moved for summary judgment based on the insured's inability to proffer any such evidence. In response, the insured contended that the "manifest intent" clause was an exclusion to coverage and, as such, the insurer had the burden of proving that it applied. The Court disagreed, and held that the clause was not an exclusion, thereby placing the burden of proof on the insured. As the insured could not offer evidence supporting a triable issue of fact on the employee's intent to obtain a financial benefit, the Court granted the insurer's motion for summary judgment. Mortgage Associates v. Fidelity & Deposit Company, 105 Cal.App.4th at 35-36.

III. Summary

In summary, the Courts have generally upheld the spirit and intent of this clause by invoking it to limit coverage, and not expand it. Virtually all courts have found the clause to be clear and unambiguous. It is generally held that the term "earned in the normal course of employment" was not intended to limit the applicability of the exclusion only to those cases where the employee intends to obtain benefits by non-fraudulent means. Fraudulently obtained employee benefits are excluded from coverage. It does not matter that the benefit was not "earned" in the literal sense. It is also irrelevant that an honest employee could not have obtained the benefit in the "normal course of employment" by means other than fraud or dishonesty. What matters is whether the intended benefit was of the general type which the employer would have knowingly conferred upon an employee in consideration of the employee's actions at work. Thus, even irregular or "one-time-only" benefits would qualify.

With respect to schemes involving employees who use dishonest or fraudulent means to steal money from payroll accounts under the guise of additional salaries or bonuses, the results are less consistent. Some courts have found these schemes clearly excluded. However other Courts have found them to be covered. Courts will look to the circumstances surrounding the transaction to evaluate whether the dishonest employee committed "pure embezzlement", which would not be excluded, or instead whether the scheme involved some manipulation of the employer's books and records with the intent on securing additional pay, which would be excluded.

Gary M. Case, Esq.
Wolf, Horowitz, Etlinger & Case, L.L.C.
99 Pratt Street, Suite 401
Hartford, Connecticut 06103
Phone: (860) 724-6667
Facsimile: (860) 293-1979
E-Mail: gcase@wolfhorowitz.com

Gary M. Case is a member of the firm Wolf, Horowitz, Etlinger & Case in Hartford, Connecticut. His practice focuses on surety, fidelity, construction, insurance coverage and subrogation. He received his undergraduate degree from Fairfield University (B. S., cum laude 1988). He received his J. D. from the University of Connecticut School of Law (J. D. with high honors, 1991), and a L. L. M. in Insurance Law from the University of Connecticut School of Law in 2003. Since 1994 he has been an Adjunct Instructor of Law at the University of Connecticut School of Law (Moot Court and Lawyering Process Programs). He has presented numerous papers concerning surety and fidelity law. He was a contributing author to the "Law and Practice of Insurance Coverage Litigation," West Group & ABA Tort and Insurance Practice Section 2000, and the "The Law of Payment Bonds, "American Bar Association, Tort and Insurance Practice Section. 1998. In 2004 Gary presented a paper on surety defenses at the ABA's "Back to Basics" program in Hartford, Connecticut.