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“FIDELITY CLAIMS - THE YEAR IN REVIEW”

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The past year saw both decisions that reaffirm certain time-honored principles of fidelity law and decisions that threaten other, similarly longstanding principles. Some of the past year's significant reported decisions are discussed below.

The concept of "direct loss" was a particularly fertile area for decisions last year. *Citizens Bank, N.A. v. Kansas Bankers Surety Co.*,¹ addressed "direct loss" appropriately. The issue presented in *Citizens Bank* was whether a "Financial Institution Crime Bond" covered a judgment a third party recovered against the Insured, arising from theft of trust assets.

The Bond covered loss resulting "directly from ... theft ... or larceny, committed by a person present in an office or on the premises of the insured, while the Property is lodged or deposited within the offices or premises of the Insured."²

Citizens Bank involved a trustee who deposited checks drawn on a trust into his personal account. The bank allowed these transactions (which were physically carried out by an employee of the trustee) in reliance solely upon the trustee's oral representations that the settlor had given him a loan out of trust assets. When the trust's attorney learned of the transactions, the trustee's powers were revoked and a new trustee was appointed. The new trustee sued the bank, alleging that the bank violated state statute by deviating from ordinary banking standards in accepting the checks. He recovered a judgment against the bank of approximately \$1.2 million. When the Insurer refused to cover the Bank's loss, the Bank sued.

The Kansas Supreme Court held that a payment the Bank may be required to make to a third party is not a "direct loss" under the Bond. The Court's analysis focused upon the bond as "property insurance". In order to obtain coverage, the Bank had to sustain a loss of property resulting from theft. The Court held that the Bank did not sustain any loss of property until it paid the judgment in the trustee's favor, which is not the same as the loss of property resulting directly from a theft committed on the Bank's premises.³

As a collateral matter, the Court also held that coverage did not exist because the trustee (the thief) was not on the bank's premises when the thefts occurred (the transactions were carried out by an innocent employee of the trustee).⁴

*Simon Marketing v. Gulf Insurance Co.*⁵ is similar. This case involved facts with which the reader may be familiar from news accounts. Simon handled promotions for McDonald's, such as Monopoly and Who Wants to be a Millionaire. A security agent for Simon, who was responsible for seeding winning game pieces around the country, conspired with accomplices to obtain and remit the winning game pieces. \$21 million in

¹ 149 P.3d 25, 2007 WL 45946 (Kan. Ct. App. Jan. 5, 2007).

² *Id.*, 149 P.3d at ___, 2007 WL 45946 at *1.

³ *Id.*, 149 P.3d at ___, 2007 WL 45946 at *4.

⁴ *Id.*, 149 P.3d at ___, 2007 WL 45946 at *6.

⁵ 149 Cal. App. 4th 616, 57 Cal. Rptr. 3d 49 (App. 2007).

winning game pieces were stolen and turned in by members of the conspiracy, with the security agent receiving kickbacks from the “prize-winning” co-conspirators.

Simon claimed that, as a result of this theft, its business was devastated. It made a claim against its bond for the “complete loss of its business” (in excess of \$60 million) and out-of-pocket costs of \$38.6 million in winding down, plus costs to settle third-party litigation, defense costs, and lost insurance proceeds that it used to settle third-party litigation. The bond contained standard language insuring for loss resulting directly from theft.

As the Kansas court did, the California court focused on the bond as “property insurance” and held that coverage did not exist for any aspect of Simon’s claim. It stated that “direct loss” means direct loss to property, *i.e.*, physical damage to insured property. Since Simon did not suffer any direct loss of property as a result of the game pieces (other than the actual, nominal value of the pieces themselves, which Simon did not seek to recover), coverage did not exist.⁶ “Not every dishonest act of an employee is an insured loss under a contract of property insurance.”⁷

While the *Citizens Bank* and *Simon* decisions are consistent with basic fidelity principles of “direct loss”, three other decisions were not so kind. *Graybar Electric Co. v. Federal Insurance Co.*,⁸ out of Missouri federal court, is diametrically opposed to the two decisions discussed above.

In *Graybar*, a contract between Graybar and another company named “Office Innovations” contained the forged signature of Graybar’s district vice president. The forgery was perpetrated by an employee of Graybar who was trying to make the deal with Office Innovations and who presumably would benefit if the deal happened. Graybar ultimately denied entering into the agreement with Office Innovations and refused to perform under the forged contract.

Office Innovations sued Graybar. The case was settled by Graybar paying nearly \$1.8 million to Office Innovations and another \$400,000 to a financier of Office Innovations. Graybar sought reimbursement for this payment under its D&O coverage and under its fidelity insurance, called an “Executive Protection Policy”. The D&O policy did, in fact, cover part of the loss, but the fidelity insurer disclaimed.

The “Executive Protection Policy” provided coverage for “direct losses of Money, Securities, or other property caused by Theft or forgery by any Employee of any Insured acting alone or in collusion with others.”⁹ The Insurer disclaimed on the ground that Graybar’s payments to settle the litigation were not covered “direct losses”.¹⁰

⁶ *Id.*, 149 Cal. App. 4th at 625, 57 Cal. Rptr. 3d at 54.

⁷ *Id.*, 149 Cal. App. 4th at 623, 57 Cal. Rptr. 3d at 53.

⁸ 2007 WL 1365327 (E.D. Mo. May 9, 2007).

⁹ *Id.* at *2.

¹⁰ *Id.* at *4.

The court held that, under Missouri law, payments to third parties can be “direct” losses under a fidelity bond. In Missouri (and other jurisdictions), whether a loss is “direct” is determined via a “proximate cause” analysis.¹¹ This court said that, under such an analysis, there is no reason that payments to third parties cannot be losses proximately caused by theft or forgery.¹² It noted that the bond did not contain any language excluding losses paid to third parties.¹³ The court concluded that, in the absence of such clear exclusionary language, the payments made by Graybar to Office Innovations and its financier were proximately caused by the forgery and thus were covered losses.¹⁴

*First National Bank v. Cincinnati Insurance Co.*¹⁵ similarly construed “direct loss” in a broader sense than intended by fidelity insurers. This case concerned the not-unusual circumstance of an auto dealer obtaining loans on the basis of forged documents. Specifically, the dealership had a relationship with the insured bank whereby the dealer would present to the bank leases signed by the dealer’s customers, and the bank would finance the dealer’s purchase of the vehicle that was the subject of the lease, with the dealer giving the bank a note, an assignment of the lease payments, and a security interest in the vehicle.

Of course, things did not always work out as anticipated. The dealer fabricated lease agreements for vehicles and transactions that did not exist and altered the terms of valid leases, forging the customers’ signatures on to the fabricated/altered lease form. He then submitted the phony documents to the bank and obtained loans for cars that did not exist (fabricated leases) and larger loans than he required for legitimate transactions (altered leases).

One of the arguments the Insurer made as the basis for denying coverage was that the Insured’s loss did not result directly from the forgery, because in many instances the underlying collateral did not exist. As the reader likely knows, the argument continues that, even if the signatures on the documents were authentic, the bank still would have sustained the loss on nonpayment because its security interests would have been worthless as a result of the absence of the collateral. Thus, the loss does not arise “directly” from the forgery; it arose from the Insured’s failure to confirm the existence of the collateral.

Surprisingly, the Seventh Circuit rejected this well-established argument. It said that the bond covered losses arising from the extension of credit in reliance upon forged documents; and that this was precisely the type of loss the bank sustained. The argument that coverage did not exist because of the lack of the underlying collateral, in the court’s opinion, “ignores the practical reality of the situation; but for the forged documents purporting to verify the existence of the collateral, credit would not have

¹¹ *Id.* at *5.

¹² *Id.* at *6.

¹³ *Id.*

¹⁴ *Id.* at *6-7.

¹⁵ 485 F.3d 971 (7th Cir. May 11, 2007).

been extended in the first place, and there would have been no loss.”¹⁶ The court also said that such an argument ignores the “plain language” of the insuring agreement, which covered loss “by reason of” the Bank “having ... extended any credit ... or otherwise acted upon any ... document” that “proves to have been a forgery.”¹⁷

It is interesting that, while the Seventh Circuit’s decision is keen on noting what the Insurer’s argument supposedly ignores, its own reasoning is based upon what appears to be fundamental disregard for the key bond requirement that loss result “directly” from the forgery. Focusing on the fact that credit would not have been extended “but for” the forgery seems to be the wrong analysis. The key issue is whether the loss resulted directly from the forgery, not whether the Insured extended credit as a direct result of the forgery. The reason this distinction is important has been discussed in many prior decisions: a fidelity bond is not credit insurance and does not insure against bad business deals.¹⁸ The mere fact that an insured extends credit in direct reliance upon a forgery is not enough. The insured also is required to exercise some type of due diligence to confirm the legitimacy of the transaction. Thus, the bond requires that the **loss** result directly from the forgery. If the loss would have been sustained irrespective of the forgery, due to the absence of the underlying collateral, then in most (if not all) cases appropriate due diligence would have led the insured to decline to enter into the transaction.

Another questionable decision that seemingly misapplied the concept of “direct loss” is *Union Planters Bank, N.A. v. Continental Casualty Co.*¹⁹ *Union Planters* is a case involving mortgage warehouse lending, which is an aspect of commercial lending that has become one of the more treacherous areas for fidelity insurers. Claims arising from mortgage warehouse lending often involve multi-million dollar losses.

In mortgage warehouse lending, a mortgage banker uses a significant line of revolving credit with a bank (the “warehouse lender”) to fund mortgages the mortgage banker issues to the home-buying public. The advances from the warehouse bank to the mortgage banker are secured by the underlying loan documents: the mortgage, note, and an assignment of the mortgage from the mortgage banker to the warehousing bank. When the mortgage banker sells the mortgage in the secondary market, it repays the warehouse lender. The bank is called a “warehouse” lender because the mortgages are “warehoused” until they are purchased in the market by a “take-out investor”.²⁰

In “wet” warehouse lending, the warehousing bank extends credit to the mortgage banker for a particular mortgage before the bank has the original mortgage documents in its possession, usually relying upon faxes of those documents. The

¹⁶ *Id.* at 980.

¹⁷ *Id.*

¹⁸ See, e.g., *Republic Nat’l Bank v. Fid. & Deposit Co.*, 894 F.2d 1255, 1263 (11th Cir.), *cert. denied*, 498 U.S. 926 (1990); *Liberty Nat’l Bank v. Aetna Life & Cas. Co.*, 568 F. Supp. 860, 863 (D.N.J. 1983).

¹⁹ 478 F.3d 759 (6th Cir. Feb. 27, 2007).

²⁰ For an excellent discussion of mortgage warehouse lending and how claims involving it are not typically covered by fidelity insurance, see Charles L. Armstrong, Thomas H. McNeill, & James E. Reynolds, *Warehouse Lending Losses Under the Financial Institution Bond*, XII FID. L.J. 1 (2006).

original underlying loan and security documents are provided to the bank after the funds have been advanced and the closing occurs. While proceeding in such a fashion allows for the fluidity that the industry claims to require, the lack of original documents prior to the advance of significant funds is eminently susceptible to fraud.

Union Planters involved a “double funding” scheme. The mortgage banker, Greatstone, had one legitimate set of loan documents, for a legitimate set of transactions. It thereafter created a duplicate, phony set of loan documents for the same transactions, forging the signatures of the underlying borrowers on the note and mortgage. The legitimate documents went to one warehouse lender, which funded the legitimate transaction. The bogus, forged documents subsequently went to Union Planters, which made a corresponding advance to Greatstone, believing that it was funding the same transaction, when in reality its funds were being stolen by Greatstone’s principals. After fraudulently obtaining \$25 million from Union Planters, Greatstone’s principals absconded with the money to Costa Rica.

One of the grounds the Insurer cited in denying the claim was that the loss was not “direct” because the underlying collateral did not exist. Specifically, the collateral that secured the advance – the assignment of the “mortgage” to Union Planters – had no value because the real, valid mortgage already had been assigned by Greatstone to the legitimate warehouse lender. The Sixth Circuit analyzed “direct loss” in terms of “proximate cause” and said that the losses were indisputably proximately caused by the insured warehouse lender’s reliance on “a pool of forged collateral”.²¹

The court did not address prior cases holding that a loss is not “direct” if the collateral underlying the transaction does not exist. It did, however, attempt to distinguish another recent warehouse lending decision, *Flagstar Bank FSB v. Federal Insurance Co.*,²² on the ground that, in *Flagstar*, the collateral was worthless because all of the borrowers were fictitious. *Union Planters* involved borrowers and properties that actually existed. The import of this distinction for “direct loss” purposes is not clear. In both cases, the underlying collateral was worthless from inception. In *Union Planters*, even if the signatures on the notes and mortgages were legitimate, the loss still would have been sustained because the mortgages could not be assigned to Union Planters, having already been assigned to the “legitimate” lender.

In rejecting the “worthless collateral” argument, the Sixth Circuit also said “if the loans had borne legitimate signatures, they would have had value”.²³ If the fact that a the loan document with authentic signatures would have had some nebulous, nominal value was relevant, then the notion that a loss is not “direct” because the collateral securing the loan does not exist would *never* be a defense to the insurer. The true “value” to be considered is the value of the security underlying the note.

²¹ *Id.* at 764.

²² 2006 WL 3343765 (E.D. Mich. Nov. 17, 2006).

²³ 478 F.3d at 765.

One of the common aspects of decisions that appear to be misconstruing the concept of “direct loss” is the reliance upon a “proximate cause” analysis. While fidelity insurers may reasonably argue that “direct loss” (a contract concept) is not equivalent to “proximate cause” (a tort concept), and that, if they intended to cover losses “proximately” caused by a forgery or a theft, their bonds would say so, the reality is that a number of courts have issued decisions equating “direct loss” with “proximate cause”. If fidelity insurers want to limit coverage to those losses that would not have been sustained “but for” the forgery or theft, as opposed to those losses that merely “proximately” result from the forgery or theft, then it may be time for fidelity insurers to consider a more specific definition of “direct loss” in their bonds, at least in those bonds being written in jurisdictions that employ a proximate cause analysis.

Another reason *Union Planters* is an important decision is because there are few reported decisions involving fidelity claims arising from the very risky practice of “wet” funding. The bond in *Union Planters* provided coverage for loss resulting directly from the Insured having “acted on an Original Financial Document [a defined term] which bears a Forgery Actual physical possession ... is a condition precedent to [the Insured] having acted in reliance upon the Financial Document.”²⁴

There was no dispute that, when Union Planters advanced money to Greatstone to fund a particular mortgage, Union Planters did not have “actual physical possession” of the original transaction documents; it had only fax copies. Union Planters argued that it satisfied the bond’s actual physical possession requirement because any particular advance was made in reliance upon original forged financial documents in its possession from prior advances. The court accepted this argument, saying that the very nature of revolving credit, which the Insurer was held to have insured, permits the borrower to engage in this type of borrowing.²⁵ It also said that the bond did not contain any provision precluding coverage under such circumstances.²⁶

This does not seem to be a fair interpretation of the bond. A more reasonable reading of the bond leads one to conclude that the fidelity insurer never intended to insure against losses arising from the risky practice of “wet” funding, where the overwhelming reliance is on *copies* of loan documents. The bond seems to make clear that losses arising from reliance upon non-original documents will not be covered. Because, however, in the Sixth Circuit’s view in this case, ambiguities in an insurance contract are to be construed against the insurer (ignoring the fact that the bond was based upon the standard form and that the other party to the insurance contract enjoyed equal bargaining power), the Sixth Circuit interpreted the bond against the Insurer and has saddled fidelity insurers with the burden of specifically excluding “wet” funding losses or risk being held liable for them under such policy language.

Flagstar could be the counterweight to the *Union Planters* “direct loss” holding except for the fact that it is a mere trial-level decision. In *Flagstar*, the defalcating

²⁴ *Union Planters*, 478 F.3d at 763.

²⁵ *Id.* at 763-64.

²⁶ *Id.* at 764.

mortgage banker forged promissory notes and related loan documents and supplied those documents to the insured warehouse lender, Flagstar. The forged documents pertained to completely fictional transactions and used stolen identities (this scheme thus differed from the “double funding” scheme in *Union Planters*).

As in *Union Planters*, the bond in *Flagstar* required that the loss arise “directly” from, *inter alia*, reliance on forged documents. *Flagstar* involved the significantly less risky “dry” funding – that is, Flagstar had the original, forged notes in its possession before making the corresponding advance to the mortgage banker.

The *Flagstar* court rejected Flagstar’s argument that its loss was covered and awarded summary judgment to the Insurer. The court found that Flagstar’s loss did not result “directly” from reliance on any forged document, because “the underlying transactions represented by the [forged] notes never took place, rendering Flagstar’s collateral worthless.”²⁷

One of the *Flagstar* court’s statements seems to cut to the heart of the difference between “direct loss” and “proximate cause”, and why a “proximate cause” analysis to determine direct loss is inappropriate:

“[E]ven if the signature were genuine, the real value of the notes, i.e. the promise to pay money, still did not exist. Consequently, Flagstar’s loss did not result directly from the forgery, **even if the forgery may have caused Flagstar to enter into the transaction.**”²⁸

In fact, the *Flagstar* court expressly rejected decisions that employ a “proximate cause” analysis, stating that such decisions “inexplicably rely on tort concepts to define an unambiguous term in an insurance contract.”²⁹

The *Flagstar* court’s decision seems to be much more in line with basic principles of fidelity insurance and contract law. Interpreting “direct loss” to mean “proximate cause” is improperly mixing tort and contract concepts, and is rewriting the bond from what the parties agreed, transferring it into a policy of credit insurance.³⁰

Ohio Savings Bank v. Duncanson,³¹ is a positive decision for fidelity insurers, involving the table funding of mortgages (as opposed to warehouse lending).³² In *OSB*,

²⁷ *Flagstar*, 2006 WL 3343765 at *11.

²⁸ *Id.* at *10 (emphasis added).

²⁹ *Id.* at *15.

³⁰ *Id.* at *13.

³¹ 2006 WL 2583413 (D. Minn. Sept. 6, 2006).

³² In “table funding”, the loan is funded entirely by the lending bank in exchange for an assignment of the mortgage loan.

the Insured table funded a number of mortgages originated by a mortgage banker, AIM. The closing agent to whom OSB disbursed the advances for these mortgages was First National Title. James Niblock, FNT's president, stole \$1.1 million of the funds advanced by OSB, pertaining to 8 loans. As a result, OSB received only one payment with regard to those loans, and the mortgages and assignments of mortgage that were to be recorded on OSB's behalf disappeared.

The Insured asserted coverage under Insuring Agreement "E", contending that it relied upon mortgage instruments that were "lost or stolen". The Insured also asserted coverage under a "Fraudulent Mortgages" rider, which provided coverage for losses resulting from mortgage instruments that were defective due to signatures obtained by virtue of trick, artifice, fraud, or false pretenses.

The Court rejected both grounds for coverage asserted by the Insured and upheld the Insurer's disclaimer. OSB was not entitled to coverage under Insuring Agreement "E" because there was no proof that the mortgage instruments were lost or stolen when OSB advanced funds to FNT. The fact that the mortgage instruments were lost or stolen subsequent to the advance did not create coverage.³³ Similarly, coverage did not exist under the "Fraudulent Mortgages" Rider because there was no evidence that OSB's loss resulted from anyone misleading borrowers into signing the mortgage instruments.³⁴ The Insurer thus was awarded summary judgment.

Two positive decisions for fidelity insurers arose out of a scam perpetrated by Tri-State Armored Services.

Tri-State serviced ATMs for various banks, restocking them with cash and returning extra cash to its bank customers. The way Tri-State's business was supposed to work was that its bank customers would wire money to a local bank, which Tri-State would pick up and take back to its offices. At its offices, Tri-State would unbundle the cash, sort it for each ATM to be serviced, and place the funds in cassettes to be inserted into each ATM. The cassettes were then taken to the ATMs. When replacing a cassette in a particular ATM, the "old" cassette that Tri-State removed from the ATM inevitably would have cash in it. That cash would be taken back to Tri-State's office, where it was counted, the balance confirmed by comparison to the ATM tape, and then taken to the local bank where it was to be deposited into Tri-State's customer's account.

Within a month of starting business, Tri-State was skimming cash that either was to be deposited into ATMs or was to be returned to its customers' accounts. Whenever a client alleged that there was a shortfall, Tri-State would make up the shortfall with another customer's money. Eventually the house of cards collapsed and Tri-State filed for bankruptcy protection. A variety of claims were asserted against two fidelity bonds – one issued on Tri-State's behalf and one issued on behalf of one Tri-State's customers, Palm Desert National Bank.

³³ 2006 WL 2583413 at *3.

³⁴ *Id.* at *4.

The case involving Tri-State's fidelity bond is *In re Tri-State Armored Services, Inc.*,³⁵ and concerns the Insurer's attempt to rescind it. The additional facts pertinent to this case are as follows:

In 1997, Tri-State's customers required that Tri-State obtain bonding. Tri-State's insurance agent submitted an application to Lloyd's, which declined to issue bonding because there was a loss already under investigation. He then submitted the application to Great American. Great American retained a security consultant, who conducted an investigation. Great American ultimately decided to issue bonding on certain conditions, including that Tri-State comply with the security consultant's recommendations within 60 days. The decision does not reflect whether Tri-State did so. As of this time, Tri-State already had used \$80,000 of its clients' money for its own expenses.

The bond was renewed the following year based upon a renewal application Tri-State submitted. In response to questions regarding "all claims and occurrences that may give rise to claims for the prior five years", Tri-State responded "N/A". Tri-State did not respond to "please provide descriptions of all losses in excess of \$5,000, including corrective action". Great American did not conduct a further investigation or follow up. Of course, during this time, Tri-State was appropriating its customers' funds for itself.

In connection with the 1999 renewal, Great American conducted another security review of Tri-State's facility. The consultant identified five areas of "significant concern". The underwriter's risk analysis, however, cited only a lack of random credit checks of employees. Tri-State's renewal application contained the same non-answers as in the 1998 renewal application. Again, during this time Tri-State had been stealing its clients' funds.

In June 2000, Great American's security consultant faxed Great American a news report that one of Tri-State's directors had been arrested for "pilfering millions of dollars meant for automatic teller machines" and "for allegedly stealing money from the company starting in 1996."³⁶ Tri-State falsely advised Great American that the investigation did not involve Tri-State or any of its customers. Great American accepted this information without further inquiry.

In connection with its October 2000 renewal, Tri-State reported no claims or losses, and Great American again renewed coverage.

In February 2001, Tri-State advised Great American that it was ceasing operations and that there may be a significant cash shortage. A month later, Tri-State filed for bankruptcy protection. Great American then filed an adversary proceeding to rescind the policy on the ground that Tri-State knowingly provided false information in the renewal applications. The bankruptcy trustee and additional insureds (Tri-State

³⁵ ___ B.R. ___, 2007 WL 1196558 (D.N.J. Apr. 23, 2007).

³⁶ *Id.*, 2007 WL 1196558 at *4.

customers) asserted various claims against Great American and opposed Great American's attempt to rescind the bond, for a variety of reasons.

The District Court affirmed the Bankruptcy Court's order allowing Great American to rescind the bond and dismissing all claims against Great American. It rejected the argument that Great American did not rely upon the false information contained in the applications by virtue of its failure to conduct follow-up investigations. Tri-State was not absolved of its obligation to respond truthfully on the applications by virtue of Great American's failure to undertake an investigation.³⁷ Moreover, Great American's right to rely upon the information provided by the insurer was not diminished thereby, absent Great American obtaining information that exposed the falsity of the representations or placed Great American on a duty of further inquiry.³⁸ Because there was no proof that Great American had any reason to doubt the accuracy of Tri-State's representations, this condition was not met.

The Court said that, even though Great American's underwriting process was less than perfect, the Insured was obligated to provide thorough and complete information on the renewal applications irrespective of Great American's investigative efforts. Great American would be obligated to investigate only if there were sufficient facts disclosed that "seriously impair the value of the application."³⁹ Under New Jersey law, where the insurer does not know that the insured's representations are false, even if "red flags" are raised by the application responses, the insurer's failure to investigate does not vitiate the insurer's right "to reasonably rely on the presumed truthfulness of the information in the application."⁴⁰ "An insurer who engages in poor underwriting practices does not forfeit its right to rescind a policy if the insured has misrepresented material information in the policy."⁴¹ This is true even if the rescission causes innocent beneficiaries to lose the benefit of the bond.

The second case arising out of the Tri-State theft is *Palm Desert National Bank v. Federal Insurance Co.*,⁴² which involves a claim by Palm Desert National Bank against its own fidelity bond. Palm Desert sustained a loss of just under \$1 million as a result of the Tri-State fraud, and asserted a claim for "in transit" coverage. The bond's "in transit" provision provided coverage for:

Loss of Property resulting directly from common law or statutory larceny, misplacement, mysterious unexplainable disappearance, damage or destruction, while the Property is in transit anywhere:

³⁷ *Id.* at *10-11.

³⁸ *Id.*

³⁹ *Id.* at *10.

⁴⁰ *Id.*

⁴¹ *Id.* at *11.

⁴² 473 F. Supp. 2d 1044 (C.D. Cal. Feb. 5, 2007).

- A. in an armored vehicle, including loading and unloading thereof;
- B. in the custody of a natural person ... as a messenger of the [Palm Desert], or
- C. [not relevant here].

Coverage under this INSURING CLAUSE begins immediately on the receipt of such Property by the natural person ... and ends immediately on delivery to the premises of the addressee or to any representative of the addressee located anywhere.⁴³

The Insurer denied coverage on the ground that the money stolen from Palm Desert was not “in transit” when stolen by Tri-State, and the court agreed.

The Insured argued that the money was “in transit” from the time Tri-State picked it up at the local bank until the time it replenished the ATMs. The court rejected this argument because it was an undisputed fact that the thefts occurred while the money was at Tri-State’s office.⁴⁴ Under California law, cargo is not “in transit” when there is a break in transit to perform work on the cargo.⁴⁵ Such was the case here, as Tri-State performed work on the money (the cargo) at its office – either unbundling and sorting money wired by its customers for deposit into ATMs or preparing money retrieved from ATMs for deposit into its customer’s accounts. The court concluded that the money was not “in transit” at the time of the thefts and upheld the Insurer’s denial of the claim.

Systems Design Corp. v. CNA Ins. Co.,⁴⁶ which concerns the alter ego doctrine, proved that good fidelity bond decisions *can* come out of New Jersey.

This case involved a small company, run by two men – Stockdale and Troutman. Troutman was the President and minority shareholder; Stockdale was the Vice President and majority shareholder. They apparently had a falling out, and Troutman allegedly took equipment, customer lists, computer programs, and client contacts from the business. The Insured made a claim under its employee dishonesty coverage, and the Insurer disclaimed coverage.

The decision does not quote the bond’s definition of “employee”, but it states that the bond excluded loss resulting “from any dishonest or criminal act that you or any of your partners commit whether acting alone or in collusion with other persons”.⁴⁷

⁴³ *Id.* at 1047.

⁴⁴ *Id.* at 1045, 1050.

⁴⁵ *Id.* at 1049-50.

⁴⁶ 2006 WL 2191963 (N.J. Super. A.D. Aug. 4, 2006).

⁴⁷ *Id.* at *1.

The New Jersey appellate court adopted the decision of the trial court, which upheld the Insurer's denial of the claim on several grounds, including the conclusion that Troutman should be considered to fall within the ambit of the alter ego doctrine. It based this decision on the fact that Troutman was President of the Insured and was one of the two principal shareholders. Even though Troutman was not, technically, a "partner", the court said that Troutman was more than an employee, and analogized his standing to that of a partner:

This is not a large publicly held corporation, but a small closely held company, two people, basically a partnership that [has] been incorporated. But it is the [c]ourt's opinion that Troutman was a partner in the business, he was a shareholder and the coverage does not apply to him even though he was the president of the company.⁴⁸

The court also said that the mere fact that Troutman received W-2 wages did not, in and of itself, mean that he could not be considered an alter ego of the Insured.⁴⁹

Another positive decision, on anti-stacking, came out of Pennsylvania. In *JEP Management, Inc. v. Federal Insurance Co.*,⁵⁰ the Insured sought coverage under two separate bonds. Its first bond provided \$5 million in crime coverage. As of June 1, 2002, that bond was replaced by a second bond that provided \$2 million in coverage. The second bond provided that the first bond terminated as of the inception date of the second bond. The first bond contained typical anti-stacking language. While not discussed in the opinion, these bonds were, apparently, either "discovery" or "claims made" policies.

On July 22, 2002 (nearly two months after the inception of the second bond), the Insured discovered that an employee had embezzled \$7 million. It reported the loss to the Insurer on September 18, 2002. The Insurer paid the \$2 million limit under the second bond, and the Insured sued for an additional \$5 million (the limit of the first bond) or, in the alternative, an additional \$3 million, contending that the loss should have been covered by the first bond and not the second.

The Pennsylvania court found the anti-stacking provisions to be unambiguous and granted summary judgment to the Insurer. What is interesting about the decision is the court's rejection of the Insured's attempt to rely upon the "doctrine of reasonable expectations". The court said that, under Pennsylvania law, the doctrine applies only to ambiguous contract language and to non-commercial insureds: "The [Pennsylvania] Supreme Court has identified only two applications for the doctrine of reasonable expectations: protecting non-commercial insureds from policy terms which are not readily apparent; and protecting non-commercial insureds from deception by insurance

⁴⁸ *Id.* at * 4.

⁴⁹ *Id.*

⁵⁰ 2006 WL 2372961 (Ct. Common Pleas Phila. Cty. Aug. 8, 2006).

agents.”⁵¹ Because the Insured here was a commercial entity, and because the anti-stacking language was not ambiguous, the court rejected the application of the doctrine of reasonable expectations.

⁵¹ *Id.* at *3.