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FIDELITY CLAIMS - THE YEAR IN REVIEW

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FIDELITY CLAIMS – THE YEAR IN REVIEW

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The past year of decisions involving fidelity insurance continued the trend of many (but not all) courts interpreting bond terms reasonably. Some of the more notable decisions are discussed below.

Occurrence

The past year saw several decisions that appear to reject the flawed rationale of cases like *Gentilini Ford*.² In *Beckley Mechanical, Inc. v. Erie Insurance Co.*,³ for example, an employee of the insured falsified records to conceal that she had written nearly 300 checks payable to herself, totaling nearly \$425,000. The insurer determined that the theft constituted a single “occurrence” and tendered payment of the per-occurrence policy limit of \$10,000. The policy defined “occurrence” as “[a]ll loss caused by, or involving, one or more employees, whether the result of a single act or series of acts”.⁴ The court determined that the policy’s definition of “occurrence” was not ambiguous; that, under this definition, the theft constituted one occurrence; and that the insurer’s liability to the insured was capped at the \$10,000 amount paid.

The court in *Aldridge Electric, Inc. v. Fidelity & Deposit Co. of Maryland*⁵ concluded that an embezzlement that occurred over a number of years – and which involved two distinct methods of embezzlement – constituted one occurrence. As in *Beckley Mechanical*, the policy defined “occurrence” as “[A]ll loss caused by, or involving, one or more employees, whether the result of a single act or series of acts.”⁶

In *Aldridge*, the defalcating employee embezzled more than \$3.5 million from employee benefit plans by (a) arranging phony loans and negotiating the checks issued for such loans, and (b) falsely representing that an employee had been terminated, resulting in the withdrawal of that employee’s money from the plan, which the defalcator then paid to herself. The insurer paid the \$500,000 policy limit, on the ground that the embezzlement constituted one occurrence.

The court agreed. It held that the employee’s acts constituted a “series of related acts” and, thus, one occurrence. Employing Illinois law, the court focused upon the cause of the damages sustained, which was the employee’s embezzlement. The fact that the employee used differing tactics to carry out the embezzlement did not require a different conclusion. The key consideration was that the employee’s scheme had the

¹ The author acknowledges with appreciation and gratitude the substantial and valuable assistance of Melissa Brown, a 2009 summer associate with Wolff & Samson.

² *Auto Lenders Acceptance Corp. v. Gentilini Ford, Inc.*, 181 N.J. 245, 854 A.2d 378 (2004).

³ 2009 WL 973358 (S.D. W. Va. April 9, 2009).

⁴ *Id.* at *3.

⁵ 2008 WL 4287639 (N.D. Ill. Sept. 10, 2008).

⁶ *Id.* at *1.

single primary aim of diverting money illegally from the insured plans to herself, and thus the differing tactics were properly considered a “series of related acts”.⁷

The court in *Pine Belt Automotive, Inc. v. Royal Indemnity Co.*⁸ – a New Jersey federal court case – reached a similar conclusion. The defalcating employee conducted his embezzlement scheme by converting checks written to the auto dealership for which he worked into money orders, which he then negotiated to himself. The court held that this scheme constitute a single occurrence, rejecting the insured’s contention that discovery might reveal that the employee “batched and cashed the money orders several times”, for multiple occurrences.⁹ The court said that the critical inquiry is whether “there was but one proximate, uninterrupted, and continuing cause which resulted in all of the injuries and damages.”¹⁰ Notably, the court also said that dicta from *Gentilini Ford*, which distinguished the facts presented in that case from “the myriad of embezzlement-type cases where an employee steals cash or checks from an employer as part of an ongoing scheme to defraud” supported the determination that the employee’s action constituted a single occurrence.¹¹

Direct Loss

The past year saw several courts shun the “proximate cause” interpretation of “direct loss” in favor of the plain language of the bond. One such case was *First State Bank v. Ohio Casualty Insurance Co.*¹² In this case, over a three-month period the defalcator carried on an extensive scheme of writing and exchanging worthless checks from the defalcator’s empty account at another bank for money orders from the insured bank. Eventually, the scheme collapsed, and the bank was left holding more than \$300,000 in worthless checks. While the defalcator’s actions were fraudulent, the bank employees’ dealings with him violated bank policy. Consequently, the insurer contended that the loss was not a “direct loss”, arguing that the breach of bank policy was an intervening cause.

The Seventh Circuit rejected the insurer’s argument, stating that the issue is one of contract and not tort, and thus principles such as “intervening cause” are not applicable.¹³ It held that, under the plain meaning of “direct loss”, the loss sustained by the insured resulted directly from the fraud: the bank’s assets were depleted as a result of the fraudulent transactions and the bogus checks being returned unpaid.¹⁴ Any “intervening causes” did not render the loss any less “direct”.

⁷ *Id.* at *7.

⁸ 2008 WL 4682582 (D.N.J. Oct. 21, 2008).

⁹ *Id.* at *5.

¹⁰ *Id.*

¹¹ *Id.*

¹² 555 F.3d 564 (7th Cir. 2009).

¹³ *Id.* at 570.

¹⁴ *Id.* at 571.

In *Direct Mortgage Corp. v. Nat'l Union Fire Ins. Co.*,¹⁵ an employee of the insured mortgage company falsified documents necessary to close loans that were sold to other financial institutions. After discovering the fraud, those financial institutions demanded that the insured buy back the mortgages, under warranty clauses in the purchase agreements. Upon settling with its customers, the insured filed a claim against its financial institution bond, seeking to recover its liability to the third-party financial institutions. The insurer rejected the claim on the ground that the insured did not suffer a “direct loss” as a result of the fraud.

The Utah federal court agreed. It rejected the proximate cause standard for determining whether a loss is “direct”, holding that employing a tort standard effectively ignores the term “direct” and is inconsistent with the nature of fidelity bonds, which exclude coverage for compensatory damages owed due to an indirect loss.¹⁶ Instead, the court adopted the “direct means direct” standard, which required focusing upon whether the insured suffered an actual depletion of funds as an immediate result of the employee’s misconduct.¹⁷ Since a “direct loss” does not include liability of an insured to a third party, there was no coverage.¹⁸ Such liability in this case was theoretical, depending upon whether the third parties elected to enforce their rights against the insured, and thus was too contingent to be considered “direct”.¹⁹

The employment of the “direct means direct” standard in *Phillip R. Seaver Title Co. v. Great American Insurance Co.*²⁰ led to the insurer being held liable for what the Michigan federal court considered to be a direct loss. In this case, the insured’s employee embezzled funds from an escrow account, causing the insured to replenish the embezzled funds. The Court, purporting to employ a “direct means direct” standard, held that the money the insured held in escrow was property “for which [the insured] was legally liable” and that the diminution in the escrow fund was an actual depletion of the insured’s assets.²¹ The Court cited the “unique facts” of this case to distinguish other decisions holding that reimbursement of a third party is an indirect loss for which coverage does not exist.²²

Other Coverage Issues

In *Oriental Financial Group, Inc. v. Federal Insurance Co.*,²³ a federal court in Puerto Rico properly concluded that a mere bookkeeping loss was not recoverable under a fidelity bond. The pertinent part of this decision involved a claim that the insured bank’s employees manipulated bank records, causing the insured to sustain a loss resulting from its inability to realize certain assets. The court upheld the jury’s

¹⁵ 625 F. Supp. 2d 1171 (D. Utah 2008).

¹⁶ *Id.* at 1175-76.

¹⁷ *Id.* at 1176-77.

¹⁸ *Id.* at 1177-78.

¹⁹ *Id.* at 1178.

²⁰ 2008 WL 4427582 (E.D. Mich. 2008).

²¹ *Id.* at *4.

²² *Id.*

²³ 598 F. Supp. 2d 199 (D.P.R. 2008).

verdict supporting the insurer's denial of the claim, stating that "[u]nder a fidelity bond, bookkeeping or theoretical losses that are not accompanied by actual withdrawals of cash or other such pecuniary loss, are not recoverable."²⁴ The court further explained: "[l]anguage in a fidelity bond to the effect that the insured is covered for 'losses directly resulting from . . .' indicates a direct loss or the actual depletion of bank funds caused by the employee's dishonest acts" and that "[t]herefore, false or negligent accounting entries can only result in a loss under a fidelity bond if, as a result of them, money leaves the bank."²⁵ The evidence indicated that the write-off of the loss was merely an account adjustment and not an actual pecuniary loss, further supporting the court's determination.

The *Oriental Financial* decision is also noteworthy because it permitted the introduction of evidence of the insured's negligence to establish that the loss was caused by such negligence and not the employees' dishonest conduct. While "negligence of the insured does not release the insurer from liability absent a clear and specific contractual limitation or circumstances that amount to fraud or bad faith on the part of the insured",²⁶ the evidence at issue went to causation – why certain documents were lost – and this evidence reflected that the employees' dishonesty was not a direct cause of the insured's loss.²⁷

In *Palm Hill Properties, L.L.C. v. Continental Insurance Co.*,²⁸ the insured property owner sustained a loss when an employee initiated a scheme that involved misrepresenting the status of apartment rentals by fabricating documents and computer records and manipulating accounts. These acts resulted in the insured paying the employee bonuses that the employee did not earn (paid for rentals that did not exist). The insured's claim against its commercial crime policy sought, *inter alia*, recovery for the payment of the unearned bonuses and lost rental income. The court rejected the insured's claim for the bonuses and rental income because the employee's motivation for the acts that caused these purported losses was to obtain compensation, which was expressly excluded from the policy's definition of "financial benefit". Since the policy required that the employee act with the manifest intent to obtain a "financial benefit", and since compensation and bonuses were excluded from the definition of that phrase, the court held that the policy did not cover the bonuses or lost rental income.²⁹

The appellate court in *First Mountain Mortgage Corp. v. Citizens Insurance Co.*,³⁰ reversed an award to the insured that provided recovery for noneconomic damages paid to third parties. In *First Mountain*, the insured was sued by a customer for alleged tortious acts of the insured's employees, which involved, among other things, the misappropriation of the customer's funds. Following a trial, the customer obtained a judgment against the insured for \$480,000, solely for noneconomic damages (based

²⁴ *Id.* at 210.

²⁵ *Id.* at 210.

²⁶ *Id.* at 212.

²⁷ *Id.* at 213.

²⁸ 2008 WL 4303817 (M.D. La. 2008).

²⁹ *Id.* at *4.

³⁰ 2008 WL 4604689 (Mich. App. 2008).

upon claims of negligent supervision and training of the employees). The insured obtained a judgment over against its fidelity insurer for the \$100,000 policy limit, for “employee dishonesty” (even though the dishonest employees had repaid the funds that they misappropriated).

On appeal, the judgment against the insurer was reversed. The appellate court held that fidelity bonds do not cover noneconomic losses: “employee dishonesty policies insure against the risk of property loss through employee dishonesty and, while the policies may cover the loss of third-party property possessed by an insured, they are not liability policies and do not protect employers against tortious acts that their employees commit against third parties.”³¹

The appellate court also reversed the lower court’s curious determination that the insurer had a duty to defend the insured in the customer’s tort litigation. The bond did not contain a duty to defend, and therefore the insured was not entitled to an award of the attorney’s fees and costs it incurred in defending the customer’s claim.³²

Limitations

The courts issued several interesting decisions addressing limitations issues for claims against fidelity bonds. The first of these is *Millstone v. St. Paul Travelers*,³³ from a Maryland appellate court. In *Millstone*, the insured became aware in October 2002 that an employee had misappropriated funds. It delayed reporting the loss to its fidelity insurer until March 2005, and filed its proof of loss in April 2005. When the insurer declined to issue payment, the insured filed suit in January 2006. One of the insurer’s defenses was the expiration of the bond’s limitations period, which required suit within 3 years from the date of discovery.

The insurer contended that, since the insured apparently discovered the loss in October of 2002, the suit was untimely. The insured countered that the bond’s limitations period violated Maryland statute, which precludes an insurance policy from shortening a statutory limitations period. The insured argued that, under Maryland law, the applicable statute of limitations was 3 years from breach by the insurer, and that the policy’s limitations period – 3 years from discovery of the loss – impermissibly shortened that period and thus was void, as the statute expressly provides.³⁴ The insurer responded by contending that the relevant statute of limitations is 3 years from “accrual” of the cause of action, and that the language triggering the limitations period upon discovery merely defined when a claim against the bond “accrues” for limitations purposes.

The trial court held for the insurer and dismissed the case, but the appellate court reversed. It held that a contract claim does not accrue until there is a breach, and thus

³¹ *Id.* at *3.

³² *Id.* at *5.

³³ 183 Md. App. 505, 962 A.2d 432 (2008).

³⁴ Md. Ins. § 12-104.

“the statute of limitations for breach of contract could not begin to run before the insured had made a claim against the insurer for [benefits under the policy]”³⁵ The limitations period therefor could not have begun to run “until the [insurer] was called upon to perform its obligations under the [policy], and that date, at the very earliest, was April 6, 2005 [the date proof of loss was submitted]. Consequently, a suit filed on January 23, 2006, would have been well within the three year statute of limitations that is generally applicable to contract actions.”³⁶

The court indicated that parties to an insurance policy can define when a claim against the policy accrues for limitations purposes, but concluded that the language of the subject bond was in reality an abbreviated limitations period and not merely a definition of “accrual”. In the court’s view, the key consideration is that the language establish the date upon which an insured may commence an action for breach of the bond.³⁷

In *Ward Management Co. v. Westport Insurance Corp.*,³⁸ a broad statutory interpretation by a Wisconsin federal court resulted in a favorable result for the insurer. In January 2001, the insured began to suspect that several employees were stealing from his Pizza Hut restaurant. Despite firing two employees for suspected theft in August 2001, he continued to experience cash shortages through 2003 that, he believed, resulted from theft. In October 2003, he hired a private investigator, who discovered that 8 employees were stealing from the restaurant. The insured terminated these employees in November 2003. In December 2003, the insured gave the insurer initial notice that the insured would be seeking coverage under the dishonesty provision of his Building and Personal Property part of his Commercial Property policy. The insured did not submit proof of loss until June 2005, and sued the insurer in February 2008.

The insurer moved for summary judgment on limitations grounds. The policy contained a limitations provision requiring suit within 2 years “after the date on which the direct physical loss or damage occurred.”³⁹ The insured argued that, irrespective of the policy’s limitations period, the applicable limitations period actually was Wisconsin’s 6-year general limitations period for actions on insurance policies.

The court granted the insurer’s motion and dismissed the claim. It held that the pertinent statute of limitations was Wisconsin’s one-year limitations period for “fire insurance” claims. “Fire insurance” under Wisconsin law is a “generic term that applies to all types of property indemnity insurance”,⁴⁰ and includes insurance policies covering theft, “which is another type of damage to real or personal property.”⁴¹ “Wisconsin courts have construed the term ‘fire insurance’ broadly to include policies covering

³⁵ *Id.*, 183 Md. App. at 511, 962 A.2d at 436.

³⁶ *Id.*, 183 Md. App. at 512, 962 A.2d at 437.

³⁷ *Id.*, 183 Md. App. at 515, 962 A.2d at 438.

³⁸ 598 F. Supp. 2d 923 (W.D. Wis. 2009).

³⁹ *Id.* at 924.

⁴⁰ *Id.* at 926.

⁴¹ *Id.*

losses other than losses from fire.”⁴² The court also noted that public policy supports strict interpretation of the statute, as doing so “protects the insurer from stale claims and creates a strong incentive for the party with the most control over its own losses to monitor them carefully.”⁴³ Giving the insured the benefit of the more generous two year limitations period contained in the policy, the insured’s claim was time-barred.⁴⁴

In *Federal Deposit Insurance Co. v. St. Paul Cos.*,⁴⁵ the court held that, under Colorado law, the notice/prejudice rule is not applicable to fidelity bond claims. The claim in this case arose from a fraud that caused a loss of an estimated \$40 million. When several employees of the insured bank (BestBank) were made aware of the fraud in 1996 – including BestBank’s 100% shareholder, its president, and its CFO – they joined in the scheme. The FDIC was appointed BestBank’s receiver July 1998, provided notice of the loss to the insurer in August 1998, and provided a proof of loss in January 1999.

One of the issues was the insured’s alleged failure to comply with the policy’s requirement that the insured provide notice of loss within 30 days after the loss was discovered.⁴⁶ The FDIC argued that, assuming the insured did not provide timely notice, the insurer needed to establish that it was prejudiced by such failure in order to deny coverage. The court rejected the argument, holding that, under Colorado law, the rule requiring the insurer to demonstrate prejudice does not apply to fidelity bonds. The rule applies only to liability policies, as the reasons for the rule, such as the unequal bargaining power between insurer and insured, are not present in the fidelity bond context.⁴⁷

Miscellaneous Topics

In Transit

Palm Desert National Bank v. Federal Insurance Co.,⁴⁸ is the latest decision arising from the Tri-State armored car fraud discussed in the past two installments of this paper. In this latest decision, the Ninth Circuit affirmed the lower court’s decision that, under California law, money that was in the armored car carrier’s office at time of the theft was not “in transit” as defined in policy.

⁴² *Id.* at 925.

⁴³ *Id.* at 927.

⁴⁴ *Id.*

⁴⁵ 2008 WL 3845418 (D. Colo. 2008)

⁴⁶ The decision did not determine whether the knowledge of the shareholder and officers could be imputed to the insured so as to constitute “discovery” under the policy, as the decision simply denied the insurer’s motion for summary judgment on the issue, holding that factual issues existed.

⁴⁷ 2008 WL 3845418 at **9-10.

⁴⁸ 300 Fed. Appx. 554 (9th Cir. 2008).

On Premises

Another issue in *First State Bank v. Ohio Casualty Insurance Co.*,⁴⁹ discussed above, was whether the loss occurred “on premises”, *i.e.*, when the defalcator exchanged his bogus checks for money orders, or when the bogus checks eventually were disallowed by the defalcator’s bank. The Seventh Circuit rejected the insurer’s argument that there was no coverage because the loss did not occur until the bogus checks were dishonored. It held that, for a loss to be covered, the bond requires only that the false pretenses be committed while on the bank’s premises.⁵⁰ The insured bank sustained an actual loss by virtue of those false pretenses when the defalcator’s checks were not honored. The fact that the loss may have been merely “theoretical” at the exact moment the bad checks were exchanged for money orders and that the dishonoring of the checks occurred “off premises” were of “no moment”.⁵¹

Termination of Coverage

*C.A. White, Inc. v. Travelers Cas. & Sur. Co.*⁵² is a puzzling decision that rejected the insurer’s claim that coverage as to a dishonest employee terminated as a result of the insured’s knowledge that the employee stole money from the insured years earlier.

In 1998, the subject employee stole money from the insured. The policy was issued in 2002. Its termination provision read:

This insurance is cancelled as to any “employee”:

(a) Immediately upon discovery by:

(1) You; or

(2) Any of your partners, officers or directors not in collusion with the “employees”

of any dishonest act committed by that “employee” whether before or after becoming employed by you.⁵³

The court found this termination provision to be ambiguous. Its conclusion was, apparently, rooted in the use of the word “cancellation”, as the court appeared to consider that coverage that never existed cannot be “cancelled”. Since the insurer had knowledge of the employee’s malfeasance as of 1998, coverage for that employee never existed. Thus, the court construed the provision to mean that the insured’s knowledge of an employee’s dishonesty must be obtained after the policy’s inception to

⁴⁹ 555 F.3d 564 (7th Cir. 2009).

⁵⁰ *Id.* at 569.

⁵¹ *Id.* at 569.

⁵² 2009 WL 1218691 (Conn. Super. Ct. 2009).

⁵³ *Id.* at *1.

invoke the termination clause, which the court considered to be a “common sense reading” of the provision.⁵⁴ The decision dubiously distinguished the cases cited by the insurer supporting its position, either based upon marginally different language in those termination provisions or because those cases were between 20 and 40 years old.⁵⁵

The decision concluded with these words of wisdom, apparently directed to insurers: “Certainly the plaintiff’s interpretation increases the risk borne by the insurer under the policy but the answer to that is to draft policies with clauses like some of those previously discussed in the case law that avert the risk presented by the present policy language.”⁵⁶ The court, however, did not explain what insurers should do when they draft clear provisions, yet courts still decline to enforce them as written.

⁵⁴ *Id.* at *12.

⁵⁵ *Id.* at *11.

⁵⁶ *Id.* at *13.