FOURTEENTH ANNUAL SOUTHERN SURETY AND FIDELITY CLAIMS CONFERENCE

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FIDELITY LAW UPDATE

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A. NOTICE AND DISCOVERY

In Acadia Insurance Company v. Keiser Industries, Incorporated, 743 A.2d 495 (Me. 2002), Acadia denied coverage to Keiser for loss caused by dishonest acts of an employee, on the ground that Keiser failed to provide timely notice. In 1998, Keiser discovered that an

employee, Glenn Searl, had used Keiser's credit card for his own personal use. However, Keiser failed to file a proof of loss or otherwise notify Acadia until 15 months later.

The policy provided that coverage as to any employee was cancelled immediately upon discovery by any officer or director of the insured of any dishonest act committed by that employee. The policy also required a proof of loss to be filed within 120 days after notice to the insurer. Kaiser's Board of Directors was aware of Searl's conduct in March, 1998. When confronted, Searl admitted his dishonesty and promised to repay the amount misappropriated within two weeks, which he failed to do.

The Court held that Kaiser discovered the loss and coverage had terminated, at the latest in March, 1998, when Searle failed to repay the loss within two weeks after he was confronted by Kaiser's Board. Therefore, when a proof of loss was filed in June, 1999, Kaiser had failed to meet the 120 day filing requirement. Kaiser's failure to timely file a proof of loss and provide notice prejudiced Acadia's ability to collect any loss from Searl before his assets had been liquidated.

B. DEFINITION OF EMPLOYEE

In Mansion Hills Condominium Association v. American Family Mutual Insurance Company, 62 S.W.3d 633 (Mo. Ct. App. 2001), the Missouri Court of Appeals had to determine whether an office manager for a condominium association, hired by a management company managing the condominiums, was an employee within the meaning of American Family's policy, thereby allowing coverage for acts of employee dishonesty. American Family's policy provided coverage for acts of employee dishonesty. Employees were defined as "any person employed by an employment contractor while the person was performing services for the insured under the insured's direction and control."

Mansion Hills hired KEM, a contractor, to manage the facility. KEM hired and paid the office manager, who embezzled funds from Mansion Hills. The Court ruled that the term "employment contractor" as used in the policy was ambiguous and had to be construed against the insurer to include office managers hired by a management company. Therefore, the office manager was an employee within the meaning of the policy and Mansion Hills was entitled to indemnification for its loss.

In Mountain Lodge Association v. Crum & Forster Indemnity Company, 558 S.E.2d 336 (W. Va. 2001), MLA, who operated Mountain Lodge, purchased a general insurance liability policy which included coverage for employee dishonesty. MLA acted as a general contractor on its condo renovation project. MLA's Board of Directors decided to hire Norman Tyler to be the construction manager. Tyler misappropriated funds by overbilling for services and materials. When MLA sought coverage for the employee theft, Crum & Forster denied coverage on the basis that Tyler was not an employee of MLA.

In reversing the Trial Court's grant of summary judgment in favor of the insurer, the Court said that in determining whether a person is an employee or an independent contractor, an important factor is whether the hiring party had a right to control and

supervise the work of the hired person. If MLA had the right to control Tyler, then he was an employee. The Court held that a genuine issue of material fact existed as to whether MLA retained the right to exercise control over Tyler.

C. EMPLOYEE DISHONESTY

In Scirex Corporation v. Federal Insurance Company, No. 02-1172, 2002 WL 31859456 (3rd. Cir. Dec. 23, 2002), Scirex was involved in testing the safety of experimental drugs for the relief of pain following oral surgery. Scirex claimed the nurses had violated testing rules and procedures during the experiments. As a result of employee misconduct during the experiments, Scirex suffered loss and the experiments had to be stopped. Federal had issued a crime insurance policy to Scirex providing coverage for "blanket employee dishonesty."

The District Court held that the nurses' conduct was not dishonest acts which were covered under Federal's policy because in the nurses' view, they honestly believed that they were substantially complying with the testing rules and procedures. The Court noted that the term "dishonest" and "fraudulent" depended upon the intent of the actor and the nurses did not have the intent to act dishonestly at the time they violated the testing procedures.

The Third Circuit reversed the District Court and held the nurses' conduct was dishonest. The nurses submitted records containing observations that they did not make, and sent patients home early in violation of testing protocol. The dishonest conduct and failure to follow testing procedures caused Scirex to cancel the drug trials. Thus, the conduct of the nurses resulted in direct loss to Scirex and Scirex was entitled to coverage under the policy.

In Holloway Sportswear, Incorporated. v. Transportation Insurance Company, 177 F. Supp. 2d 764 (S.D. Ohio 2001), Holloway, a clothing retail store, claimed that its former employee sold trade secrets to a competitor. Holloway sought recovery for the loss under Transportation's policy providing coverage for employee dishonesty. The policy defined covered property as "money, securities, and property other than money and securities." Property other than securities was defined as tangible property. The Court held that under Ohio law, trade secrets were intangible property and therefore, not covered under Transportation's policy.

In Pacific Enterprises v. Federal Insurance Company, No. 99-56309, 2001 WL 1029238 (9th Cir. Sept. 7, 2001), Pacific sought recovery under a crime policy issued by Federal that covered direct losses of money, securities and other property caused by theft or forgery by an employee of the insured. Pacific's subsidiary, Thrifty Corporation, permitted FTM Sports Corporation to use Thrifty's letter of credit facility. FTM's president, Robert J. Miller, engaged in fraud by preparing and submitting false invoices to obtain letters of credit on Thrifty's credit line. The Ninth Circuit reversed the District Court's grant of summary judgment and found Pacific had raised genuine issues of material fact. The Court noted that to overcome summary judgment, Pacific need not establish the exact amount of its loss.

In Cincinnati Insurance Company v. Tuscaloosa County Parking and Transit Authority, No. 1001329, 2002 WL 254108 (Ala. 2002), two employees of the Authority embezzled money by issuing payroll checks in excess of their salaries, used the company credit card for personal use and received kickbacks from fraudulent invoices. The Authority sought coverage under its fidelity policy issued by Cincinnati. Cincinnati denied coverage.

As a prerequisite to coverage, the Authority had to prove (1) that is loss was due to employee dishonesty, (2) that the employee committed the act with the manifest intent to cause a loss, and (3) the employee obtained a financial benefit for himself or herself. The financial benefit to the employee must have been in a form other than "salaries and other benefits earned in the normal course of employment." The Court applied the meaning of salary, which is "fixed compensation for services paid to a person on a regular basis."

The Court found that the taking of funds by issuing payroll checks did not constitute salary, because the payroll checks exceeded the fixed compensation to be paid for services. Furthermore, since the funds were stolen, they were not earned in the normal course of business. Therefore, the Authority was entitled to coverage for employee dishonesty.

D. MANIFEST INTENT

In Shoemaker v. Lumbermens Mutual Casualty Company, 176 F. Supp. 2d 449 (W.D. Pa. 2001), the administratix of a decedent's estate brought suit alleging breach of contract and bad faith as a result of Lumbermens failure to pay the benefits under an employee dishonesty policy. The policy had been issued to the employer of the former executor of the Estate, who was convicted of stealing funds from the Estate.

The Court held that the former executor did not act with the necessary manifest intent to cause a loss to the employer. The executor had used funds from the Estate for personal use. The Court, following the Third Circuit Court of Appeals' holding in Resolution Trust Corporation v. Fidelity and Deposit Company of Maryland, 205 F.3d 615 (3rd Cir. 2000), applied a specific intent standard and held that Shoemaker did not prove the executor knew or expected that his theft of funds would result in loss to the employer.

In First National Bank of Fulda v. BancInsure, Incorporated, No. Civ. 00-2002DDA/FLN, 2001 WL 1663872 (D. Minn. Dec. 21, 2001), a loan officer embezzled funds by extending lines of credit to the Bank's customers. The Bank sought coverage from BancInsure for settlement expenses to customers and ongoing litigation expenses.

The District Court held that the Bank had not proven that the employee acted with the manifest intent to cause the loss relating to the third-party lawsuits. The Court rejected the application of a purely objective manifest intent standard, but noted that a subjective state of mind should be considered. The Court defined manifest intent to be an intent "that is obvious based on the offending bank employees conduct." If a bank employee fraudulently seeks to benefit himself through acts that necessarily make the bank liable to

third parties, then the bank suffers loss just as if the employee had taken the bank's funds for his/her own use. Although the Bank showed that the employee embezzlement of funds caused the Bank to sustain loss, the Bank did not prove that the actions of the employee at issue in the litigation arose from the embezzlement. Finally, the Court held that the litigation expenses for which the Bank sought coverage were not the result of the embezzlement.

E. EXCLUSIONS

In First Insurance Funding Corporation v. Federal Insurance Company, 284 F.3d 799 (7th Cir., 2002), Federal issued a financial institution bond to First Insurance Funding ("FIF"), which provided loans to businesses that sought to finance payment of their annual insurance premiums. FIF retained Colesons Incorporated to find borrowers to submit applications to FIF for approval. Subsequently, without FIF's knowledge, Colesons began submitting fraudulent altered financial agreements to FIF. FIF then approved insurance premium financing for the false entities created by Colesons.

When FIF discovered its loss, it sought coverage under the financial institution bond. The bond provided coverage for loss resulting from fraudulent or dishonest conduct, but coverage was excluded for losses caused by "any agent, broker, factor, commission merchant, independent contractor, intermediary, finder or other representative of the same general character of the Assured." Federal asserted that Colesons was not a finder or intermediary, and therefore, the exclusion did not apply.

In dismissing FIF's claim, the Court held that the policy expressly excluded coverage for loss caused by a finder or an intermediary. The Court held that Colesons functioned as a finder or intermediary for FIF. Colesons brought business to FIF in order to allow FIF to form business relationships and ultimately, business transactions. Therefore, the policy excluded coverage for loss FIF suffered from Colesons' dishonesty.

In Finkel v. St. Paul Fire and Marine Insurance Company, No. OO CV 1194 (AVN), 2002 WL 1359672 (D. Conn. June 6, 2002), the Plaintiff, Chapter 11 Bankruptcy Trustee for KPM, Inc., a payroll administrative company, brought suit against St. Paul to recover for loss sustained by customers who filed proofs of loss with the bankruptcy estate. The customers sustained losses when KPM's director, David Kast, misappropriated the customers' funds. St. Paul argued that the Employee Dishonesty Rider only provided coverage for direct loss of property resulting from employee dishonesty by KPM, not indirect loss. The policy also excluded loss that is an "indirect result of any act or event covered by this agreement, including but not limited loss resulting from payment of damages of any type for which you are liable."

In granting St. Paul's motion for summary judgment, the District Court held that the policy unambiguously limited coverage to indemnification of the insured for direct loss from employee dishonesty and did not insure against legal liability of the insured to third parties caused by an employee's dishonesty. The Court concluded that KPM did not sustain a direct loss, only potential legal liability to former customers.

F. TERMINATION OF COVERAGE

In American Casualty Company of Reading, Pennsylvania v. Etowah Bank, 288 F.3d 1282 (11th Cir. 2002), CNA issued a financial institution bond to Etowah to provide coverage against loss resulting from theft, forgery or employee dishonesty. During the bond period, Regions Bank acquired Etowah by purchasing 100% of its stock. However, Etowah continued its operations as always, under the same by-laws. Regions submitted a claim to CNA for loss, claiming it discovered the loss in October, 1998. CNA denied coverage and sought declaratory judgment that the bond terminated when Regions acquired Etowah. Regions argued that a taking over had not occurred, because Etowah continued to function as before.

The terms of the bond provided that the bond terminated immediately upon the taking over of the insured by another institution. The Eleventh Circuit held that the term "taking over" for purposes of termination under the bond occurred when more than 50% of the insured's stock was acquired.

The Court rejected Regions Bank's assertion that the Court apply the "core functions" test, noting that the "core functions" test was not to be used where stock ownership had changed, but rather where regulators had taken over the insured's core functions. The Court concluded that the bond terminated when Etowah was acquired by Regions.

G. THIRD PARTY RIGHTS

In O/E Systems, Incorporated v. Inacom Corporation, 179 F. Supp. 2d 363 (D. Del. 2002), the Plaintiff, a computer equipment lessor, sued the lessee, Inacom, and the lessee's insurer to recover the cost of equipment lost when Inacom filed for bankruptcy. The Plaintiffs believed the equipment was taken by former employees and a claim was asserted for the loss under Inacom's crime policy.

The Court held that the only named insured is Inacom, and therefore, only Inacom could receive the benefits of the policy. Thus, the Plaintiff could not assert a claim.

H. RECOVERY

In Kanawha Valley Radiologists, Incorporated v. One Valley Bank, 557 S.E.2d 277 (W.Va. 2001), Kanawha Valley learned that Patricia Griffith, an employee, had misappropriated funds for her own personal use. CNA, Kanawha's insurer, paid the coverage limit for employee dishonesty of $50,000. Kanawha then began liquidating Griffith's assets to recover funds. Kanawha also asserted two civil actions, one against One Valley Bank. Before a settlement between Kanawha and the bank was completed, CNA intervened to assert a subrogation claim. The Court denied CNA's motion based on the made whole doctrine.

CNA argued that the subrogation provision in the policy was a valid contractual obligation contrary to the made whole doctrine. The Court held that "in the absence of

statutory law or valid obligation to the contrary, an insured must be fully compensated for injuries or losses sustained before subrogation rights of an insurer carrier arise." Parties may alter the doctrine by contract, but the doctrine is not altered merely by the inclusion in an insurance policy of a general statement that the insurer is entitled to subrogation.

In Berner Foods, Incorporated v. Fidelity and Guaranty Pallmeyer Insurance Company, No. 00 C 5427, 2002 WL 461702 (N.D. Ill. Mar. 26, 2002), several insurance claims arose from a business dispute between Berner Foods and Dairy Source. Each company filed suits against each other. Fidelity denied indemnification for defense costs to Berner incurred in the litigation. Berner brought suit against Fidelity for breach of contract and for indemnification under the employee dishonesty provisions for loss attributed to the fraudulent acts of its former employee.

Fidelity moved for summary judgment on the grounds that Berner's settlement with Dairy Source, without notice to Fidelity, prejudiced Fidelity's subrogation rights by releasing Diary Source and its employees. In denying summary judgment, the Court held that an insurer had the burden to show that settlement substantially prejudiced the insurer. Diary Source and Berner entered into a lump sum settlement without allocating an amount for each grievance between the parties. Because of uncertainty relating to the amount of the total settlement that represented employee dishonesty, Fidelity had not shown how the settlement substantially prejudiced it.